Part 4 Negotiable Instruments and Banking CHAPTER 18 Holder in Due Course, Liability, and Defenses Page 411 CASE OPENER Dishonored Check and Holder-in-Due-Course Status In July 1993, Cigna Insurance Company issued James Mills a workers' compensation check for $484. Then Mills lied to Cigna and said he had not received the draft due to a change in his address. He requested that payment be stopped and a new draft issued. The insurer complied, stopped payment on the initial draft, and promptly issued a new check for Mills. However, Mills cashed the first check at Sun's Market before the stop-payment notation was placed on the draft. Sun's Market then presented the check for payment through its bank. As a result of the stop payment on the initial draft, the bank dishonored the check, stamped it "stop payment," and returned the check to Sun's bank. After not receiving the cash for the bad check, Sun's Market tacked the check on its bulletin board. An individual, Robert Triffin, purchased the check from Sun's Market and obtained an assignment of Sun's interests in the instrument. More than two years after the check was returned unpaid, Triffin filed a lawsuit against Cigna for payment on the check. Triffin argued that by purchasing the check from Sun's Market, he gained a special legal status, called holder-in-due-course status. This status entitled him to payment on the dishonored check. He argued that he received this special status under the shelter principle because the transfer by a holder in due course to a third party, even one with notice of the dishonor, transfers all rights of the holder in due course to the third party. Who do you think should bear the dishonored check? In other words, should Cigna be required to pay Triffin for the dishonored workers' compensation check? Why or why not? Suppose you are a business manager at Sun's Market. You learn that the court holds that Cigna Insurance Company does not have to pay for dishonored checks. Would you make any changes to your business policies? Would you be less likely to accept checks from insurance companies in the future? Page 412 LEARNING OBJECTIVES LO 18-1 Define holder in due course. LO 18-2 Outline the requirements for holder-in-due-course status. LO 18-3 Define shelter principle. LO 18-4 Outline the necessary information to determine signature liability. LO 18-5 Define warranty liability. LO 18-6 Explain how to avoid liability for negotiable instruments.

Holder-in-Due-Course Doctrine LO 18-1 Define holder in due course. Suppose you want to purchase computers for your office building. You contract with a

computer seller, Data Corp., to buy 50 computers. As partial payment, you give Data Corp. a note for $30,000. Data Corp. negotiates the note to Data Corp's. landlord, Morgan, for payment of rent. Suppose Morgan meets all the requirements (which you will soon learn) to be a holder in due course. You discover your computers are damaged, and you claim that Data Corp. breached its contract with you. If Data Corp. still held the $30,000 note, you could refuse to honor the note and claim as a defense that Data Corp. breached the contract. However, remember that Data Corp. negotiated the note to Morgan. Since Morgan is a holder in due course, you must pay Morgan because a holder in due course has higher rights to a negotiated instrument. If Morgan were simply a holder, you could use the defense of breach of contract against Morgan. Reason for Holder-in-Due-Course Status Do you think the elevated holder-in-due-course status is fair? The purpose of holder-in-due-course status is to protect a financial intermediary. In other words, someone who processes a payment should not be required to shoulder the transaction risks. Thus, the legal system offers greater legal protection to certain parties to encourage them to engage in financial transactions.

Requirements for Holder-in-Due-Course Status LO 18-2 Outline the requirements for holder-in-due-course status. To be considered a holder in due course (HDC), a party must meet three requirements regarding the taking of the instrument. These requirements are established in UCC Section 3-302: Exhibit 18-1Holder-in-Due-Course Requirements The party must be a holder of a complete and authentic negotiable instrument, and the holder must have taken the instrument For value, In good faith, And without notice of any defects. Page 413 Meeting these requirements is very valuable, as the Case Nugget demonstrates. CASE Nugget HDC Status to the Rescue Watson Coatings, Inc. v. American Express Travel Services, Inc. U.S. Court of Appeals for the Eighth Circuit 436 F.3d 1036 (2006) Christine Mayfield used to work for Watson Coatings Inc., and part of her role there included that of company treasurer. During her time as treasurer, Mayfield wrote approximately 45-47 checks from Watson's account to American Express for personal debt totaling $745,969.39. With each check that was submitted, American Express credited Mayfield's personal account. After Mayfield was dismissed from Watson Coatings, the money she had taken was discovered and suit was filed against American Express for taking the money from Mayfield despite the checks having been clearly labeled as belonging to Watson Coatings Inc. The district court granted American Express's motion for summary judgment, but

Watson filed an appeal. In the opinion written by Judge Smith, the extent to which American Express can be considered a holder in due course of the checks written by Mayfield was considered. The judge explained that because a payee can be considered a holder in due course, American Express would qualify. However, the court also needed to decide whether holder-in-due-course status would offer any protection to American Express. The appeals court found that even though Watson had brought forth several common law claims against American Express, the fact that American Express is a holder in due course can serve as a defense. The checks had been accepted by American Express in good faith, making it the holder in due course of the documents. Thus, the court affirmed the district court's grant of summary judgment to American Express. BUT WHAT IF. . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Recall that, in the Case Opener, Mills was the original holder of the check from Cigna Insurance Company. Cigna sent Mills the check for $484, but Mills said that he never received the check, when in reality he cashed the check. So Cigna sent him a new check. Let's say, however, that Cigna realized prior to the cashing of the second check that the first check had been cashed, and due to breach of contract, Cigna now attempts to deny payment on the second check. Is Mills a holder of the check or a holder in due course? Depending on his status, will Cigna be able to refuse payment or not? Be a Holder of a Complete and Authentic Negotiable Instrument Party Must Be a Holder First, as we mentioned earlier in the chapter, to be a holder in due course, a party taking the instrument must be a holder, a party who is in possession of an instrument that is payable to the party or to the bearer of the instrument [UCC Section 1-201(20)]. For example, if Adam Brewer possesses a check that states, "Payable to Adam Brewer," Adam is a holder. However, suppose Adam asked his bank for a cashier's check to buy a boat from his friend, Corey Baum (see Exhibit 18-2). Even though Adam possesses the cashier's check and his name appears on the check, he is not a holder of the check because it is payable to his friend. When Adam gives the cashier's check to his friend, Corey, the friend becomes the first holder of the cashier's check. Page 414 Exhibit 18-2Illustration of the Relationship between Being a Payee and a Being a Holder Similarly, if someone steals a check labeled "Payable to Adam Brewer" and forges Adam's signature on the back of the check, this thief is not a holder of the check (see Exhibit 18-3). Because the check is payable to Adam Brewer and not to the thief, the thief cannot be considered a holder, even if he forges Adam's name. Exhibit 18-3Illustration of a Failed Attempt to Become a Holder through Forgery Instrument Must Be Negotiable Second, the instrument must be negotiable. A party cannot be a holder in

due course of a nonnegotiable instrument. If an instrument lacks any of the requirements for negotiability, the holder cannot be a holder in due course. Instrument Must Be Complete and Authentic Third, the negotiable instrument must be complete and authentic [UCC 3-302(a)(1)]. When the instrument is issued or negotiated, the note must appear complete and authentic. What happens if the instrument is incomplete? For example, suppose that someone writing a check forgets to write the date on the check. The UCC allows the holder to complete the check as long as the completion is consistent with the intent of the issuer (3-115). For example, suppose you write a check to a company to purchase some business supplies. Although you write the company's name, you forget to write the date. Under the UCC, the company may complete the instrument—in this instance, the check— by writing the date. However, if the person completes the instrument in a way that is inconsistent with the intent of the issuer, the instrument is considered materially altered. If an instrument has clearly been materially altered or is so irregular or incomplete that its authenticity is called into question, the UCC bars a person taking this flawed instrument from becoming a holder in due course [3-302(a)(1)]. Take Instrument for Value Page 415 The holder in due course must take the negotiable instrument "for value." In other areas of the law, taking something for value usually means taking something with consideration, a bargained-for promise. However, the for-value requirement is more stringent than consideration: the party must take the instrument in exchange for a promise that has already been performed. The UCC explicitly excludes from "value" any promises that have not yet been performed. In other words, the party must suffer an out-of-pocket loss (3-303). Why? If a party has not yet performed the promise, he or she has not completely committed financially to the transaction and thus should not receive special legal protection. Therefore, when a party receives a negotiable instrument as a gift or acquires it through mistake, the party will be a holder instead of an HDC. A holder can take an instrument for value if the holder Performs the promise for which the instrument was issued. Acquires a security interest or some other lien in the instrument. Takes the instrument for payment of a preceding claim. Exchanges the instrument for another negotiable instrument. Exchanges the instrument for an irrevocable obligation to a third party [UCC 3-303(a)]. BUT WHAT IF. . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Recall that in the Case Opener, Cigna sent Mills a workers' compensation check. What if the check was misprinted, and the monetary amount was never printed on the check? Although Mills knew the check was supposed to be for $484, he writes in the monetary amount of $1,000. Would he be able to cash this check, considering Cigna made the

mistake by not putting in a monetary amount? Take Instrument in Good Faith The HDC must take the negotiable instrument in good faith [UCC 3-302(a) (2) (ii)]. What exactly is good faith? Historically, there has been some debate about whether good faith had an objective or subjective definition. For example, when determining whether a holder took an instrument in good faith in the objective sense, some courts would decide whether the holder purchased the instrument with a proper degree of caution through a usual and ordinary manner of conducting business. Looking at good faith in an objective sense means considering what the reasonable holder would have done. However, other courts looked at good faith in a subjective sense by asking whether the holder acted honestly when taking the instrument. Looking at good faith in a subjective sense means considering the holder's actual behavior. The UCC's definition of good faith is somewhere in the middle of the subjective and objective standards. The UCC defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing" [3-103(a)(4)]. Therefore, to act in good faith, a holder must not deviate from the reasonable commercial standards of fair dealing. The UCC drafters were most concerned with the fairness of the dealing. This case explains the significance of having holder-in-due-course status. CASE 18-1 WALKER v. PROBANDT, Nebraska Court of Appeals 902 NW 2d 468 (2017) FACTS: A & G Precision Parts, LLC (Parts LLC), was a limited liability company whose members at the time of organization were Dennis Walker, John Raynor, John Probandt, John Brazier, and Walter Glass. In 2002, Parts LLC, Walker, Raynor, and Brazier obtained a loan from a bank for approximately $2.1 million. Parts LLC did not make the loan payments as required, and the bank made demand for full payment. In March 2008, the parties negotiated with First State Bank (FSB) to refinance the loan. In conjunction with the loan, Parts LLC, Walker, Raynor, Brazier, and Mark Herz signed a promissory note for $1.5 million. Under the promissory note, Walker, Raynor, Brazier, and Herz were cosigners on the loan and assumed joint and several liability for the repayment of the loan. Parts LLC defaulted on the loan, and FSB commenced this action to recover on the note. Walker entered into a settlement agreement in which FSB assigned the note to Skyline Acquisition (Skyline), which then proceeded to pursue Raynor for the rest of the money. A judgment was entered against Raynor for $2,306,244.76, which he appeals on the grounds that, among other things, Skyline is not a holder in due course. ISSUE: Is Skyline a holder in due course? REASONING: Neb. U.C.C. § 3-302 (Reissue 2001) provides that being a holder in due course means the holder takes an instrument (1) for value, (2) in good faith, (3) without notice that the instrument is overdue or has been dishonored or that there is an

uncured default with respect to payment of another instrument issued as part of the same series, (4) without notice that the instrument contains an unauthorized signature or has been altered, (5) without notice of any claim to the instrument described in Neb. U.C.C. § 3-306 (Reissue 2001), and (6) without notice that any party has a defense or claim in recoupment described in Neb. U.C.C. § 3-305(a) (Reissue 2001). Here, Skyline does not meet all of the requirements to qualify as a holder in due course. Despite the language of the assignment, it does not appear that Skyline paid value for the note; rather, as evidenced by the language of the settlement agreement, the consideration was paid by Walker, and upon such payment, FSB agreed to assign the note to Skyline. In addition, in taking the note, Skyline had notice that the instrument was overdue, because Walker and his wife are the only members of Skyline and they both signed the release which recognized the default of the note. Therefore, although Skyline is the present holder of the note, it is not a holder in due course. Raynor argues that because Skyline does not qualify as a holder in due course, it is subject to any defenses he could have asserted against FSB, and we agree. Unless one has the rights of a holder in due course, he is subject to all the defenses of any party which would be available in an action on a simple contract. Accordingly, in the present case, because Skyline is not a holder in due course, it is subject to any defense Raynor could assert against FSB in a simple contract case. In such a case, Raynor would have a defense against FSB that any amount for which he is liable on the note must be reduced by the amounts FSB already received in settling the claims for nonpayment of the note from Walker, Brazier, Herz, and/or Hansen. FSB is not allowed double recovery from multiple defendants for the same claim as to the note, and therefore, Raynor is liable only for the amount remaining on the note after subtraction of the amounts FSB received from the settling defendants. DECISION AND REMEDY: Reversed and Remanded. SIGNIFICANCE OF THE CASE: This case outlines the requirements of holder in due course status, as well as what it means to have or not have that status. CRITICAL THINKING What new information would have been necessary to change the decision in this case? ETHICAL DECISION MAKING What values are being advanced by the reasoning in this decision? Page 416 Take Instrument without Notice Finally, a holder must take an instrument without notice of various claims to or defects of the negotiable instrument. If the holder has notice or is aware of any of the following defects, the holder cannot be an HDC [UCC 3-302(a)]: Page 417 The instrument is overdue. The instrument has been dishonored. The instrument was issued as part of a series that is in default. The instrument has been altered or contains an unauthorized signature. There is a claim to

the instrument. (Such claims are described in UCC Section 3-306.) Another party has a defense or claim in recoupment to the instrument. Exhibit 18-4Notice of a Fact According to the UCC, a person has notice of a fact if any of the following are true: The person has actual knowledge of the fact, The person receives notification of the fact, The facts and circumstances of the person in question indicate that the person should know the fact exists. Essentially, to say that a negotiable instrument was accepted without notice of defects is to say that a party was not knowledgeable of any defects in the instrument at the time of acceptance. What Does It Mean to Have Notice? BUT WHAT IF. . . But suppose that Sun's Market, the check-cashing business from the Case Opener, received a letter from the insurance company that listed the numbers of checks that had stop-payment orders. As long as Sun's Market received this letter before it accidentally accepted the dishonored check, Sun's Market would have notice of a defect and thus could not be a holder in due course. The UCC states that "to be effective, notice must be received at a time and in a manner that gives a reasonable opportunity to act on it" [3-302(f)]. Suppose that a person receives an instrument that has clearly been altered; however, the person taking the instrument does not inspect the instrument and thus does not notice the obvious alteration. As stated earlier, one of the requirements of becoming a holder in due course is that the holder accepts a complete and authentic negotiable instrument [UCC 3-302(a)(1)]. Consequently, the question of a holder's awareness of such extreme irregularities does not matter; the very existence of such irregularities means that the holder cannot be a holder in due course. If a person has notice of a defect before he or she gives value for the instrument but still gives value, the person will not be able to claim holder-in-due-course status. Overdue Instruments Suppose you accept a check from a business associate. Unfortunately, the check falls behind your desk and is lost for the next four months. If you try to negotiate this instrument to another party, that party will not be permitted to claim holder-in-due-course status because the check is overdue. If a holder has notice that an instrument is overdue, the holder cannot claim holder-in-due-course status. How does a holder know whether an instrument is overdue? Overdue status depends on the type of instrument. The UCC explains how two types of instruments—demand and time instruments—may be overdue (3-304). Demand Instruments. A demand instrument, an instrument payable on demand, becomes overdue if it has been outstanding for an unreasonably long period of time after its date [UCC 3-304(a)(3)]. If the demand instrument is a check, the UCC states that the check is overdue 90 days after its date [3-304(a)(2)]. Thus, because your check has been outstanding for four months, it is overdue. The date on the

check would give another party notice of its overdue status; thus, the party cannot claim HDC status. Time Instruments. A time instrument, an instrument payable at a definite time, becomes overdue at any time after the expressed due date on the instrument. Most of the rules regarding whether a time instrument is overdue depend on the payment structure of the instrument. For example, a time instrument may or may not be payable in installments. If the instrument requires a party to make payment in a lump sum rather than in installments, the instrument is overdue if the party does not make the lump-sum payment by the due date [UCC 3-304(b)(2)]. Page 418 However, how does nonpayment of installments affect whether the instrument is overdue? Overdue status depends on whether a late payment applies to the principal or the interest on the instrument. If a party misses payment of an installment on the principal of an instrument, the instrument is overdue until this installment is paid [UCC 3-304(b)(1)]. However, if a party misses a payment of interest on this instrument, the instrument is not overdue [UCC 3-304(c)]. Why might a party have reason to know that an installment payment of principal was not made, making the instrument overdue? This information is usually included on a credit report. For example, if a bank is considering purchasing a consumer note from a retailer, the bank can determine whether all payments have been made on the note by looking at the consumer’s credit report. If the credit report indicates that an installment had not been paid, the bank would have notice that the instrument was overdue. Dishonored Instruments If a holder is aware that an instrument he or she is taking has been dishonored, the holder cannot become an HDC. An instrument is dishonored when a party refuses to pay the instrument. For example, suppose you deposit a check from a customer into your company’s account at a Wells Fargo bank. The customer has an account at Chase Manhattan. Wells Fargo credits your account and later presents the check for payment at Chase. However, Chase refuses to pay because there are insufficient funds in your customer’s account. Chase has dishonored the check and would likely stamp the phrase “insufficient funds” on your check. If you then tried to negotiate this check to another party, that party, seeing the words insufficient funds, would have notice that the check was dishonored. However, if a party has no reason to know that a note has been dishonored, the party can become an HDC. Thus, if Chase did not stamp the phrase “insufficient funds” on the check, the new party would likely not have notice that the check was dishonored. Consequently, this new party could become an HDC. Claims or Defenses If a party is aware of any claim or defense to an instrument, that party has notice and thus cannot become an HDC [UCC 3-302(a)(2)(v),(vi)]. However, if the party had no

reason to know that various claims or defenses applied to an instrument, even if the claims and defenses existed, the party could become an HDC. Exhibit 18-5 provides a summary of the defenses that do and do not apply to the holder in due course. Exhibit 18-5Defenses and the Holder in Due Course A holder in due course is generally free from personal defenses but is subject to real defenses. The holder in due course is free from the following personal defenses: Lack or failure of consideration. Breach of contract. Fraud in the inducement in the underlying contract. Incapacity. Illegality. Duress. Unauthorized completion or material alteration of the instrument. Unauthorized acquisition of the instrument. The HDC is subject to the following real defenses: Fraud in the essence. Discharge of the party liable through bankruptcy. Forgery. Material alteration of a completed instrument. Infancy—a party is below the legal age of consent. Page 419 Case 18-2 demonstrates the importance of knowing whether you have met the standards for being a holder in due course. CASE 18-2 CREATIVE VENTURES, LLC v. JIM WARD & ASSOCIATES 195 Cal. App. 4th 1430 (2011) FACTS: Creative Ventures (CV) borrowed roughly $3 million from Jim Ward & Associates (JW) to buy property in California. CV signed promissory notes, payable to JW. JW then sold the loan to 54 individual investors and kept possession of the promissory notes. CV made its payments to JW, and JW paid shares to the investors. California has a law making it illegal to charge an interest rate over 8 percent, except when the loan is made by a licensed real estate broker. JW claimed it was such a broker; it was not. CV learned of the lie and sued both JW and the investors for a refund of all interest it had already paid on the loan, as the California statute permitted. The investors claimed that, as holders in due course, they did not owe CV any interest because they had taken the note free of any claim against JW. The trial court agreed with the investors; CV is appealing. ISSUE: Does anyone claiming holder-in-due-course status need to physically possess the document for which the claim is being made? REASONING: The Appeals Court pointed out that one of the criteria for being a holder in due course is possession. JW is the holder because it has the notes. The investors were benefitting from their relationship with JW, but they did not have the promissory notes. In short, the investors could not be a holder in due course because they are not holding the notes. DECISION AND REMEDY: The only rights the investors have are those possessed by the person who offered them the original contract, JW. Therefore, CV is entitled to a full refund of the interest it has paid; the investors must return to CV all interest payments they have received. SIGNIFICANCE OF THE CASE: Knowing all the elements necessary to be a holder in due course can have significant business implications. CRITICAL

THINKING What missing information should the investors have asked JW at the point when they were purchasing the promissory notes? ETHICAL DECISION MAKING Make a list of the various stakeholders affected by this three-way transaction. In light of the Appeals Court decision, which stakeholders are they ranking as highly important and which are they ranking as not so important?

The Shelter Principle and HDC LO 18-3 Define shelter principle. Generally, if an item is transferred from one person to another, the transferee acquires all the rights that the transferor had in the item. This idea is called the shelter principle [UCC Section 3-203(b)]. Therefore, following the shelter principle, even if a holder cannot attain holder-in-due-course status, the holder can acquire the rights and privileges of an HDC if the item is being transferred from an HDC. Note that the instrument does not need to be transferred directly from an HDC for the recipient to have the rights of an HDC. Under the shelter principle, as long as the holder of an instrument can demonstrate that someone through the line of transfers had obtained the rights of an HDC, then all subsequent holders have the rights of an HDC. Page 420 Therefore, in the Case Opener, plaintiff Triffin received the workers' compensation check from Sun's Market, a holder in due course. If Triffin did not qualify for HDC status on his own, he would have received the rights that Sun's Market, the transferor, had. In other words, Triffin is taking shelter in Sun's Market's status as an HDC. One exception to the shelter principle involves cases of fraud or other illegal activities. If a person engages in fraud or other illegal interference with an instrument, he or she may not become an HDC, even if obtaining the instrument later from an HDC. The Shelter Principle exists because it is desirable for people to rely on negotiable instruments. It would be expensive for the recipient of the instrument to investigate every instrument before accepting the transfer. The rule permits an innocent person receiving the instrument to have all the rights that had existed before the transfer. The shelter principle may at first seem contrary to the idea of the HDC principle; however, the purpose of the shelter principle is to encourage the marketability of instruments. The greater protection offered to an HDC is very appealing; thus, allowing parties to achieve the rights of an HDC through the shelter principle encourages financial interactions. GLOBAL Context Digital Archive Japan/Alamy Images HDC Status in South Korea South Korea's laws regarding holder in due course status are similar to those in the United States albeit with narrower application. However, they provide even more protections to the holder in

due course and incorporate other areas of the law outside of negotiable instruments. To be a holder in due course of a negotiable instrument The holder must have acquired the note in a manner as provided by the Bills of Exchange and Promissory Notes Act (i.e., endorsement and delivery). The series of endorsements shall be apparently uninterrupted. The assignee must have an independent economic interest on the note. The note must have been acquired from a person with any defect in title. The holder must have acquired the note in good faith and without gross negligence. The most interesting factor is that holder in due course status only applies to someone who obtained an instrument in good faith from someone who had a defect in title to the instrument. However, as a consequence of this factor, the holder in due course can obtain better title than the person he or she obtained the instrument from. Additionally, if the debt underlying the instrument was created through contract, the holder in due course has the ability to have the contract assigned to him or her and effectively become a party to the contract for the purposes of enforcing the contract and collecting on the instrument.

Liability As you have seen, it is not always clear who should bear responsibility for the amount of a negotiable instrument. The following sections explain the various ways a party may be liable for a negotiable instrument. First, when a person signs a negotiable instrument, he or she is potentially liable for the instrument. This type of liability is called signature liability. Second, in contrast, a party may be liable if the transfer of the instrument breaches a warranty associated with the instrument. This type of liability is called warranty liability. After we consider both signature and warranty liability, we examine the defenses to these types of liability. Finally, we investigate how liability for a negotiable instrument may be discharged.

Signature Liability LO 18-4 Outline the necessary information to determine signature liability. UCC Section 3-401(a) imposes liability if the party, or the party’s agent, signs the instrument. If a party does not sign, the party cannot be held liable. Because the signature on an instrument leads to liability, it is important to know what counts as a signature. According to the UCC, a signature can be any name, word, mark, or symbol used by a party to authenticate a writing [3-401(b)]. Thus, if you wrote either your full name or an X with the intent to authenticate an instrument, either writing would constitute a signature. Page 421 Primary Liability of Makers and Acceptors A

party who is primarily liable for an instrument must pay the stated amount on the instrument when it is presented for payment. This liability for the stated amount begins as soon as the instrument is issued. Moreover, the primarily liable party must pay without resorting to any other party. For example, suppose you own a business and write a check drawing on your funds in your business account at First National Bank. First National has primary liability for the check; it must pay the stated amount when the check is presented for payment. The UCC establishes that certain parties—makers and acceptors—are primarily liable. First, a maker is a party who has promised to pay. For example, the maker of a promissory note is primarily liable for the amount of the note because that party has promised to pay the amount of the instrument. Moreover, UCC Section 3-412 states that a party who signs as an issuer of an instrument is liable for the amount of the instrument as soon as it is issued. For example, a bank that issues a cashier's check is primarily liable for the amount of the check as soon as the cashier's check is created (UCC 4-412). Second, an acceptor, a drawee of a draft who accepts and signs the draft to agree to pay the draft when it is presented, is primarily liable [UCC 3-413(a)]. A party who accepts a draft by signing on the face of the draft is primarily liable (UCC 3-413). For example, when a bank accepts a check, it is primarily liable for the amount of the check (UCC 3-409). Secondary Liability of Drawers and Endorsers A party who is secondarily liable for an instrument must pay the amount on the instrument if the primarily liable party defaults. Drawers and endorsers are secondarily liable parties. An endorser is a party who signs an instrument to restrict payment of it, negotiate it, or incur liability [UCC 3-204(b)]. A drawer is a person who signs as a party ordering payment [UCC 3-103(a)(5)]. For example, if you write a check from your bank account that is payable to the electric company, you are the drawer of the check, the bank is the drawee, and the electric company is the holder of the check. The holder of the check (the electric company) presents the check to the drawee (the bank) for payment. Presentment is defined in the UCC as making a demand for the drawee to pay [3-501(a)]. The UCC creates specific rules that govern the time and manner of presentment. E-COMMERCE and the Law Electronic Signatures Electronic signatures are now an accepted and rather standard method of authorizing payment. Any type of business with an online payment system puts its company at potential risk. Many banking companies have policies that deem the merchant rather than the buyer responsible for the charge if the payment made is fraudulent. For example, Visa tells those people with business accounts that make online transactions to know how to protect themselves because the business owners could be liable if payment

taken from the customer is fraudulent. There are several options for businesses looking to ensure that their online transaction system can detect fraudulent payment. One of these options is to obtain chargeback insurance to prevent liability for fraud. The second option is to increase safety measures to prevent fraud, such as having online Completely Automated Public Turing Test to Tell Computers and Humans Apart (CAPTCHA) or requiring more extensive authentication procedures when a customer makes a payment. Because online business owners are at high risk for this type of fraud, owners should always properly authenticate the customer making a payment. Source: Bahman Eslamboly, “Avoiding Problems When Using Electronic Signatures,” LawGuru.com, January 25, 2013. Suppose the holder (the electric company) presented your check and the bank dishonored the check because of insufficient funds in your account. The UCC states that drawers of drafts are liable for an instrument only after it has been dishonored (3-414, 3-415). Thus, you (the drawer) are now liable for the check. Page 422 Three conditions must be met for a drawer or endorser to become liable. First, the holder of the instrument must present the instrument in a proper and timely fashion. Second, the instrument must be dishonored. Third, notice of the dishonor must be given to the drawer. Presentment An instrument must be presented in a proper and timely manner. First, the instrument must be presented to the proper party. If the instrument is a note, the holder must present the note to the maker of the note. In contrast, if the instrument is a draft, the holder must present the instrument to the drawee. Thus, continuing our electric company example, the electric company must present the check to the bank (the drawee). Second, the instrument must be presented to the proper party in a proper way. UCC Section 3-501(b) states that an instrument can be presented (1) by any commercially reasonable means, (2) through a clearinghouse procedure, or (3) at the place designated in the instrument. Third, the instrument must be presented to the proper party in a timely manner. Thus, if the instrument is a note, the holder must present the note to the maker on the note’s due date. If the instrument is a draft, such as a check, the holder must present the instrument within a reasonable time. The failure to present an instrument on time is the most common reason that improper presentment occurs, ultimately discharging unqualified endorsers from secondary liability. Dishonor When a holder presents an instrument within a timely and proper manner but acceptance or payment is refused, the instrument has been dishonored. The instrument must be explicitly dishonored; a refusal to pay does not necessarily mean that the instrument has been dishonored. For example, suppose you are a holder of a check that is payable to your

business. You present this check for payment, but the bank refuses to pay the check because you cannot present identification [UCC 3-501(b)(2)]. Likewise, a bank may refuse to pay on an instrument because the endorsement of the instrument is not proper. Again, this refusal to pay does not dishonor the instrument. Remember, a secondarily liable party becomes liable only if a primarily liable party dishonors the instrument. Notice of Dishonor The UCC provides a specific time line in which notice of dishonor of an instrument must be given to a secondarily liable party (3-503). (The process of determining secondary liability is summarized in Exhibit 18-6.) If the party that dishonors an instrument is a collection bank, it must give notice before midnight of the next day [UCC 3-503(c)]. Other parties must give notice of the dishonor within 30 days of the day on which they receive notice of dishonor. This notice can be given in any commercially reasonable manner: oral, written, or electronic communication [UCC 3-503(b)]. The notice must identify the instrument in question and state that this instrument has been dishonored. If the word dishonored appears on the instrument, this writing is enough to constitute notice. As long as the holder gives notice to the secondarily liable parties about the dishonor of the instrument, the holder can sue the other parties. Exhibit 18-6Summary of Process of Determining Secondary Liability NOTE DRAFT To whom must the holder present the instrument? Maker Drawee When should the instrument be presented? On due date Reasonable time; if a check, within 30 days of date of check or within 30 days of time of endorsement If the instrument is presented and dishonored, who is usually now liable for the instrument? Any endorser Drawer or endorser What are the requirements for an instrument to be officially dishonored so that a holder may then turn to secondarily liable parties? Present to maker for payment Maker dishonors Holder gives notice of dishonor to secondarily liable parties (endorsers) Present to drawee for payment Drawee dishonors Holder gives timely notice of dishonor to drawer or endorsers Page 423 If all three of these conditions are met, the holder can bring suit against a secondarily liable party. However, in most cases, although a secondarily liable party may have to pay a holder the amount of the instrument, the secondarily liable party can then seek recourse against the primarily liable party. If an instrument contains more than one endorsement, each endorser is liable for the full amount to any subsequent endorser or to any holder. The secondary liability established through endorsement requires an endorser to pay anyone who endorses the instrument after them. Accommodation Parties Suppose that, after you graduate from college, you decide to start your own business. You need to borrow a significant amount of money from the bank, and you plan to create

a promissory note. However, because you have never owned your own business and have little credit history, the bank is a little wary about whether you will be able to pay the note. Therefore, the bank decides to ask you to have a third party sign the note to ensure that the bank will be paid. Consequently, your business law professor cosigns your note. This third party is called an accommodation party, a party who signs an instrument to provide credit for another party who has also signed the instrument [UCC 3-419(a)]. Accommodation parties may be primarily or secondarily liable for an instrument and can sign as makers, drawers, acceptors, or endorsers. However, accommodation parties more frequently sign as makers or endorsers. As a maker, an accommodation party has primary liability, but as an endorser, the party has secondary liability. Suppose you, in the preceding example, cannot pay your note, and your business professor, as an accommodation party, pays the note instead. This professor has a right of reimbursement to recover the money from you, the accommodated party [UCC 3-419(e)]. If, however, you, the accommodated party, pay the note when it is due, you cannot force the professor to contribute to the amount due on the loan. Unauthorized Signatures and Endorsements As a general rule, if a signature to a negotiable instrument is unauthorized, the signature will not impose liability to the named party. This rule applies to two cases: forgery and unauthorized agents. First, return to the preceding accommodation party example. Suppose you forged your business law professor’s name to ensure that you would get your money to start your new business. If you could not pay on the note, your business law professor would not be forced to pay on the basis of the forged signature. Similarly, this rule applies to parties who forge the drawer’s signature on a check. However, forgery in the employment context is treated differently, as we explain below in the section entitled “The Fictitious-Payee Rule.” Second, if an agent is not authorized to sign a negotiable instrument on behalf of a principal, the principal will generally not be liable for the instrument. Consequently, the agent would be personally liable for the instrument. However, if the principal decides to ratify, or approve of, the unauthorized agent’s signature, the principal will then become liable for the instrument, and the agent will escape personal liability [UCC 3-403(a)]. How does a principal ratify an unauthorized signature? A principal could explicitly approve of the signature. For example, a Florida court held that a principal could not recover the amount of two checks he gave to his agent because the principal had ratified the signatures.1 The agent, who was supposed to deposit two checks into the principal’s account, forged the principal’s signature and deposited the checks into the agent’s account. The agent ultimately told the principal

about the forged checks and the location of the money. The principal did nothing until the agent later ran away with the money, and the court ruled that the principal’s inaction was the same as his approval of his signature. Page 424 Alternatively, if the principal accepts the benefits associated with this unauthorized signature, the principal in effect ratifies the signature by their conduct. For example, in Rakestraw v. Rodriguez, a husband had forged his wife’s signature to obtain a loan to start a grocery store.2 A few days later, the wife discovered the forgery, but she did nothing to correct it and even participated in the business over the next few years. Part of running the business included sharing in the profits from the grocery store. When the business failed, the wife tried to avoid liability, claiming her husband forged her signature. The court ruled that her actions in sharing in profits and in helping run the business effectively ratified her signature. This ratification of an unauthorized signature does not exclusively apply to the agent–principal relationship. Your business law professor could similarly choose to ratify your unauthorized signature of his name and thus would be liable for your promissory note. However, these are some exceptions to the general rule that an unauthorized signature is not enforceable. Generally, the policy behind these exceptions is that courts want to place the burden on the parties who are in the best position to take a loss or take action to recover a loss. Moreover, particularly in regard to the last two rules that are discussed shortly (the imposter rule and the fictitious-payee rule), the court focuses on the intent of the party who is issuing the instrument. Negligence In some cases, a party’s negligence does not permit the party to escape liability for an unauthorized signature. If the party whose signature was forged behaved so negligently as to “substantially contribute to . . . the making of a forged signature,” the party might not escape liability (UCC 3-406). For example, in Thompson Maple Products v. Citizens National Bank, Thompson was a corporation that manufactured bowling pins from maple logs.3 Thompson would accept loads of logs from timber owners. When a load arrived at the mill, a Thompson employee filled out a scaling slip that listed the name of the owner along with the quantity and grade of the logs. Thompson office employees then used the slips to prepare checks for the owners of the logs. A Thompson employee, Emery Albers, filled out blank scaling slips for fictitious loads of logs. The office employees, thinking the slips represented real loads of wood, then prepared checks for payment. Albers forged the name of the owner of the logs and cashed the checks or deposited them into his bank account at Citizens National Bank. The court ruled that Thompson “substantially contributed” to the forgeries because the blank scaling slips used to record loads of logs were easily accessible. In fact, office employees

gave Albers two entire pads of these slips. Moreover, even though it was company policy for the slips to be initialed by authorized employees who were accepting the loads, Thompson office employees created checks even for slips that were not authorized. Thus, Thompson's negligence led to the conclusion that Thompson should be liable. The Imposter Rule Suppose that Jamaar, a business manager, has been communicating through email with Carlie, a potential employee. Jamaar has scheduled a meeting with Carlie. However, Samantha, without Carlie's knowledge, decides to impersonate Carlie at the interview. Samantha (as Carlie) tells Jamaar she will strongly consider signing an employment agreement if Jamaar will issue her a $200 check as a presigning bonus. Jamaar agrees and issues the check to Carlie that day. Samantha forges Carlie's name and deposits the check into her own account. Will Jamaar be liable for the amount of the check? Jamaar's signature has not been forged; he clearly signed the check with intent to transfer money to Carlie. But he did not know that Carlie was actually Samantha. Is Samantha's signature considered a forgery? No. Under the UCC's imposter rule, if a maker or drawer issues a negotiable instrument to an imposter, the imposter's endorsement will be effective [UCC 3-404(a)]. The court considers the intent of the drawer or maker when issuing the instrument. Because Jamaar intended for Samantha (as Carlie) to have the instrument, her endorsement of the instrument is considered valid. Moreover, it is easier for Jamaar as maker or drawer to identify the true identity of Carlie than it would be for a later holder of the check to do so. Perhaps you are surprised by the imposter rule. The UCC, as stated, places an immense responsibility on Jamaar to ensure that he is not being duped. What values are in conflict here? Should Jamaar be forced to shoulder this responsibility? Page 425 The Fictitious-Payee Rule Suppose now that Jamaar, who has been authorized to write checks from the company account, draws bonus checks from the company account for five more potential employees. Unfortunately, Jamaar never actually interviewed these employees; thus, these people are not entitled to the bonuses. Jamaar endorses these checks, which are made out to the fictitious potential employees, in their names and deposits the checks in his personal bank account. These potential employees have no interest (i.e., no right to payment) in the checks and are thus called fictitious payees (UCC 3-404, 3-405). As with the endorsement in the imposter case, Jamaar's endorsement of the fictitious payees is not considered forgery [UCC 3-404(b)(2)]. Jamaar's company will be liable for the checks. Why is the company liable? Courts view the company as being in a better position to bear the loss of the checks. The loss has occurred because Jamaar, a company employee, has acted wrongly. Although the company is

liable for the amounts of the checks, the company can recover the money from Jamaar.

Warranty Liability LO 18-5 Define warranty liability. In the previous section, we explained how a party might be liable for an instrument on the basis of their signature on the instrument. In this section, we consider another type of liability: warranty liability. A party may be liable for an instrument because of a breach of warranty. There are two relevant types of warranties here: transfer warranties and presentment warranties. Transfer Warranty A negotiable instrument can be transferred from one party to another. A party who transfers a negotiable instrument to another party in good faith for consideration creates transfer warranties regarding the instrument and the transfer itself [UCC 3-416(a)]. Transfer warranties always apply to the party to whom the instrument is transferred (the transferee). When a party transfers an instrument for consideration, they warrant that The transferor is entitled to enforce the negotiable instrument. Signatures on the instrument are authentic and authorized. The instrument has not been altered. The instrument is not subject to a defense or claim in recoupment. The transferor has no knowledge of insolvency proceedings against the maker, acceptor, or drawer of the instrument [UCC 3-416(a)]. If the transfer is through endorsement, these warranties apply to any future holders. However, if the transfer does not occur through endorsement, the warranties apply only to the transferee. These rules on whether the warranties apply to future holders or only to the immediate transferee are important because liability can be imposed for breach of warranty. If the warranties apply and there is a breach of one of the warranties, the parties can bring suit against the transferor, the warrantor, for damages suffered as a result of the breach [UCC 3-416(b)]. As soon as a transferee discovers that a breach of warranty has occurred, they can bring suit against the transferor. However, the transferee must give notice of the breach-of-warranty claim to the transferor within 30 days of discovering the breach [UCC 3-416(c)]. If the transferee does not give notice within 30 days of discovering the breach, the warranty will be discharged to some extent. If the transferred instrument is a check, the warranties cannot be disclaimed [UCC 3-416(c)]. Although warranties on checks cannot be disclaimed, they can be disclaimed on other instruments. When parties agree to a disclaimer, an endorser can disclaim warranties by including in the endorsement the phrase without warranties. Without warranties disclaims warranty liability. Page 426 Presentment Warranty In the “Signature Liability” section, we discussed the requirements for a negotiable instrument to be

properly presented for payment. Certain warranties are associated with the presentment of an instrument. Remember, presentment occurs when a party properly presents an instrument for acceptance and the party to whom it was presented accepts the instrument or pays it in good faith. Why are presentment warranties needed? Parties who accept or pay instruments may worry that they are not paying the proper party. Thus, whereas transfer warranties apply to the transferee, presentment warranties cover parties who accept instruments for payment. Both the party presenting the instrument and any previous transferor of the instrument make presentment warranties. Therefore, if there is a breach of presentment warranty, the acceptor can recover damages from the presenting party or previous transferors. As with the notice rule for transfer warranties, a party must give notice of a breach of presentment warranty within 30 days. There are two types of presentment warranties. These types depend on what kind of instrument is being presented to a certain kind of party. When a party presents an unaccepted draft to a drawee, the holder guarantees The warrantor of the instrument is entitled to enforce the instrument. The instrument has not been altered. The warrantor has no knowledge that the drawer’s signature or the draft is unauthorized [UCC 3-417(a)]. These warranties apply only to a drawee who pays or accepts a draft in good faith. If the instrument is not an unaccepted draft presented to a drawee, only one presentment warranty applies. The party presenting the instrument guarantees that the warrantor is or was entitled to payment or authorized to obtain payment [UCC 3-417(d)(1)]. In other words, only warranty 1 in the preceding list applies to presentments of instruments other than unaccepted drafts.

Avoiding Liability for Negotiable Instruments LO 18-6 Explain how to avoid liability for negotiable instruments. If a party tries to enforce a negotiable instrument, a defendant can try to avoid liability in two ways. First, the defendant can try to claim a defense to liability. Second, the defendant can try to claim that the liability has been discharged. Defenses to Liability Earlier in the chapter, we listed defenses to liability that do or do not apply to a holder in due course. Here, we return to these defenses to liability. There are two categories of defenses: real defenses and personal defenses. Real defenses, also called universal defenses, apply to all parties. Personal defenses do not apply to holders in due course. Real Defenses A party’s right

to enforce a negotiable instrument is subject to the following real defenses: Infancy (being below the legal age of consent), to the extent that it makes a contract void. Duress, to the extent that it makes a contract void. Lack of legal capacity, to the extent that it makes a contract void. Illegality of the transaction, to the extent that it makes a contract void. Fraud in the factum. Discharge through insolvency proceedings (bankruptcy). Forgery. Material alteration. Page 427 The first six defenses are stated explicitly in UCC Section 3-305. As we discussed earlier in this chapter, the UCC establishes forgery as a defense to liability because a party must have signed the instrument to be held liable. Finally, a material alteration of an instrument discharges a party of a liability [UCC 3-407(a)]. Fraud in the Factum. When a party signs a negotiable instrument without knowing that it is, in fact, a negotiable instrument, the party can claim fraud in the factum (also called fraud in the execution and fraud in the essence) as a defense. For example, suppose Michael Jordan believes he is signing an autograph for a fan, but he is actually signing a promissory note. Because he did not intend to sign a negotiable instrument, he will not be held liable for the instrument. Similarly, suppose you, a business manager, are negotiating with another company to purchase materials for your manufacturing business. After your negotiations, the company asks you to sign a document as a preorder for the materials. You hurriedly sign the document and leave. However, instead of signing a preorder, you have actually signed a note. Will you be held liable for this note? In this case, it depends on the extent to which you, as the signing party, had reason to know what you were signing. For another illustration of these issues, see the Case Nugget. CASE Nugget Defense of Ignorance? Laborer’s Pension Fund v. A & C Envtl., Inc. U.S. Court of Appeals for the Seventh Circuit 301 F.3d 762 (2002) A & C Environmental Inc. is a corporation that transports and disposes of nonhazardous waste. In April 1999, A & C was asked to complete a job in Gary, Indiana, which prompted representatives from Laborer’s Pension Fund to approach the company. Frattini of the fund asked Clark of A & C to sign a form that would guarantee the five individuals who would work in Gary, Indiana, the coverage of the local union. Clark was hesitant to sign the agreement because he feared that if someone within his company were covered under the union, the entire company would then be covered. It wasn’t until after Frattini guaranteed Clark that the only employees of A & C who would be affected would be those working in Gary, Indiana, that the agreement was signed. When A & C did not pay dues for all of its employees, the fund brought suit for delinquent contributions. The district court ruled against the fund as a result of the fraud-in-the-execution defense that was brought forth by A & C. The court

decided that any reasonable juror would believe that Clark did not know that he was agreeing to pay the fund dues for each employee of A & C. The fund appealed to the U.S. Seventh Circuit Court of Appeals. In the opinion written by Judge Ripple, the Seventh Circuit found that Clark may not have known what he was agreeing to. Unlike the district court, however, the appeals court found that Clark had a reasonable opportunity to review the document, which was written in English. Although Frattini had misrepresented the contents of the document to Clark, there was an opportunity to review the document that established dues for all employees of A & C. Thus, the court of appeals reversed the decision of the district court. Page 428 Although fraud in the factum is a real defense, courts have held that the signer's experience may determine whether the signer should have known what they were actually signing. Recall the situation with Jamaar in which he was solely responsible for ensuring the identity of the individual he was signing a check to. However, that level of responsibility is not required of Michael Jordan in the situation described earlier. Can you account for the difference in the two situations, pointing out the differing values and ethical norms? As another example, consider Schaeffer v. United Bank & Trust Co.4 United Bank sued Schaeffer to collect on a promissory note Schaeffer had signed as an accommodation maker. However, the Maryland court ultimately ruled that Schaeffer was not liable due to fraud in the factum. It turns out Schaeffer barely knew how to read, did not understand the document he was signing, and was lied to by the note's maker, who had told Schaeffer that Schaeffer's signature would serve as a character witness. The court ruled that United Bank was not a holder in due course and was subjected to Schaeffer's defense even if the bank were a holder in due course because the note was void due to fraud in the factum. Material Alteration. The UCC defines a material alteration as "an unauthorized change in an instrument that purports to modify in any respect the obligation of a party, or an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party" (3-407). Only unauthorized changes that affect the rights of the party are considered material alterations. Changes that typically fall under UCC Section 3-407 include changes to the parties to the instrument, the amount of the instrument, the date the instrument is due, and the applicable interest rate. If the material alteration is fraudulent, the party whose rights have been affected by the change is completely discharged from the instrument [UCC 3-407(b)]. However, if the material alteration is not fraudulent, the instrument will be enforced only under the original terms. Personal Defenses Personal defenses apply to holders, not holders in due course. Personal defenses can be divided

into two categories. First, general defenses can be asserted against the defendant on general contract theory. These defenses include Breach of contract or warranty. Lack or failure of consideration. Fraud in the inducement. (See the following Case Nugget for an example of how the courts consider the defense of fraud in the inducement.) Illegality. Mental incapacity. Second, the UCC lists specific personal defenses created by provisions of Article 3. These defenses, summarized in Exhibit 18-7, include the following: Defense of nonissuance, conditional issuance, or issuance for a special purpose [3-105(b)]. Defense of modification or nullification of an obligation by a separate agreement (3-117). Defense of nondelivery of the instrument [3-105(b)]. Defense of unauthorized, nonfraudulent completion of an instrument (3-115). Exhibit 18-7Summary of Defenses to Liability for a Negotiable Instrument Real (universal) defenses Infancy (below the legal age of consent)* Duress* Lack of legal capacity* Illegality of the transaction* Fraud in the factum Discharge through Insolvency proceedings Forgery Material alteration Personal defenses Contract defenses: Breach of contract or warranty Lack or failure of consideration Fraud in the Inducement Illegality Mental Incapacity Article 3 defenses: Nonissuance of an instrument Modification of an obligation by a separate agreement Nondelivery of the instrument Unauthorized, nonfraudulent completion of the instrument * To the extent that it makes a contract void. Discharge of Liability on Instruments When a party’s liability for a negotiable instrument is terminated, this party’s liability has been discharged. In other words, the party is released from liability. Discharge can occur through a variety of ways. For example, as stated earlier, discharge of endorsers can occur if a party who has a right to enforce an instrument has materially altered the instrument. Keep in mind that discharge is not effective against a holder in due course (UCC 3-601). Page 429 CASE Nugget Fraud in the Inducement Hugh L. Caraway v. Land Design Studio Texas Court of Appeals 47 S.W.3d 696 (2001) Internacional Realty hired Land Design to perform landscaping services on an apartment complex development known as the Deerfield Project, resulting in a debt owed to Land Design for work completed on the project. Land Design later told Caraway, the president of Realty, that it needed to remove Realty’s account receivable from Land Design’s books to continue receiving working capital from its lender. The parties created a promissory note that essentially replaced Realty’s account receivable. In September 1998, the parties executed the note. The note was to be paid in full no later than March 31, 1999; however, no payment was received. Land Design demanded payment and brought suit in July 1999 to collect the amount due. Land Design filed suit against Caraway. In response, Caraway denied liability, asserting several

defenses, one being fraud in the inducement. Specifically, Caraway asserted that Land Design orally represented to him that the note would not be due until Realty closed on its Deerfield Project construction loan, thus fraudulently inducing him to sign the note. However, this type of parol evidence is generally inadmissible to alter the terms of a promissory note. On the basis of the specifics of the case regarding parol evidence, the court determined that Caraway must show that some type of trickery, artifice, or device was employed by Land Design in addition to showing that Land Design represented to him that he would not be liable on the note. However, Caraway's summary judgment proof failed to present any evidence of trickery or artifice by Land Design. Caraway's only evidence was his repeated assertion in his affidavit (and two supplemental affidavits) that Land Design promised that the note would not be due until Realty closed on its construction loan. Even if correct, this was insufficient. A mere representation to a maker, without some accompanying trickery or artifice, will not defeat the application of the parol evidence rule. Caraway's claim of fraudulent inducement was further weakened by the fact that the promissory note itself makes a reference to closing on the loan. The note states: "Should Debtor close on the property prior to March 31, 1999, payment shall be made within three (3) days of Debtor's receipt of funds. . . ." The deadline for payment was March 31, 1999. Therefore, trickery is unlikely when the note references the event that Caraway claims is the event triggering his obligation to pay. Because of Caraway's reliance on the assertions in his affidavit regarding Land Design's promise and the fact that such evidence is inadmissible under the parol evidence rule, Caraway offered no evidence to raise a genuine issue of material fact. Therefore, the court concluded that no factual question existed of fraudulent inducement. Page 430 Discharge through Payment and Tender of Payment Earlier in this chapter, we discussed how a party becomes liable for an instrument by signing the instrument. If a party (or another party on the first party's behalf) who has signed an instrument has an obligation to pay and then pays the full amount due, all parties who are liable will be discharged (UCC 3-602). For example, Stuart creates a note in which he promises to pay Vanessa $1,000. If Stuart pays the $1,000 on the due date, he will be discharged from liability on the note. However, if Stuart makes the payment on the note to John, knowing that John stole the note from Vanessa and is wrongfully possessing it, Stuart's obligation will not be discharged. Paying John does not discharge Stuart's liability because John, who stole the note, is not a holder and is not entitled to the amount on the note [UCC 3-602(b)(2)]. Moreover, some parties' obligations on an instrument will be discharged if the obliged party tenders full payment on

the due date but the holder of the instrument refuses to accept the money [UCC 3-603(b)]. If Stuart makes a proper tender of the full amount ($1,000) to Vanessa on the note's due date but she improperly refuses to accept the money, Stuart will still be liable for the $1,000 but will not have to pay interest on the amount. However, if any endorsers or accommodation parties are liable for Stuart's note, these parties' obligation will be discharged. Discharge by Cancellation or Renunciation A party who is entitled to enforce an instrument may decide to cancel the instrument with or without consideration. Canceling the instrument discharges the obligation of a party who must pay the instrument (UCC 3-604). The party who decides to cancel the instrument may engage in an intentional voluntary act to cancel the instrument. For example, the party might write "Paid" on the instrument, intentionally destroy or mutilate the instrument, or give the instrument to the obliged party. Alternatively, a party may renounce an instrument by promising not to sue to enforce the instrument. Renunciation occurs when a party agrees, in writing, not to sue the obliged party. Discharge by Reacquisition Reacquisition occurs when a former holder of an instrument has the instrument transferred back to him or her by negotiation or other means. When reacquisition occurs, anyone who endorsed the instrument in between the initial acquisition and the reacquisition by the holder has his or her endorsement canceled. When an endorsement is canceled, discharge occurs. The holder who reacquired the instrument can further negotiate the instrument, but the intermediate endorsers will not be held liable (UCC 3-207). Discharge by Impairment of Recourse A right to recourse is the ability of a party to seek reimbursement. Typically, when a holder presents an instrument to an endorser, the endorser can seek recourse from prior endorsers, the maker, the drawer, or accommodating parties. However, if the holder has in some way impaired the endorser's ability to seek recourse from any of these parties, the endorser is not liable on the instrument [UCC 3-605(i)]. Discharge by Impairment of Collateral If a party posts collateral to ensure his performance of the negotiable instrument and the holder of the collateral impairs the value of the collateral, the party to the instrument is discharged from the instrument to the extent of the damage to the collateral [UCC 3-605(d)]. Page 431 CASE OPENER WRAP-UP Dishonored Check and Holder-in-Due-Course Status In this case, the court ruled in favor of Triffin and ordered Cigna to pay him $484 plus interest for the check. Even though Triffin knew the check was dishonored when he purchased it, he still was able to receive payment under the shelter principle and holder in due course. That is, the court ruled that the transfer by a holder in due course to a third party, even one with notice of the dishonor, transfers all rights of the holder

in due course to the successor in interest. As discussed earlier in the chapter, the purpose of the holder-in-due-course doctrine is to protect financial intermediaries and encourage them to continue to engage in financial transactions. If you were a manager for Sun’s Market and discovered that the insurance company would not be responsible for the dishonored check, you would probably be less likely to accept checks in the future. The holder-in-due-course doctrine and shelter principle encourage market transactions and shield businesses like Sun’s Market from unnecessary risks. PRACTICAL TIPS for Business Managers If you pay a party with a negotiable instrument and that party negotiates that note to a third party, HDC status means that you are obligated to pay that third party even if the first party wronged you. If you seek recourse, it must be against the party that wronged you, not the third party. On the other hand, if someone is taking action against your business for an instrument you received from another party, remember the protections that HDC status provides you with and that the shelter principle can protect you even if you would normally be just a holder. Some firms you try to do business with may try to abuse the protections of HDC status. If this attempt happens, remember that there are rules against certain abuses, such as taking instruments in bad faith. In other words, HDC status is not necessarily bulletproof, and you may have options of recourse.

SUMMARY Holder-in-Due-Course Doctrine The HDC doctrine provides incentive for financial intermediaries to engage in transactions because they receive greater legal protection. Requirements for Holder-in-Due-Course Status Be a holder of a complete and authentic negotiable instrument. Take the instrument for value: The holder must suffer an out-of-pocket loss. Take the instrument in good faith: The holder must take the instrument with “honesty in fact and the observance of reasonable commercial standards of fair dealing.” Take the instrument without notice: The holder must take the instrument without notice of the following defects: it is overdue, is dishonored, or is part of a series in default; it has been altered or has an unauthorized signature; or it is subject to claims or defenses. The Shelter Principle and HDC Shelter principle: If a holder cannot attain HDC status, the holder can acquire the rights and privileges of an HDC if the item is being transferred from an HDC. Signature Liability A party can be held liable for an instrument only if the party has signed the instrument. Primary liability of makers and acceptors: They must pay the stated amount on the instrument when it is presented for payment. Secondary liability of drawers and endorsers: They must pay the amount on the instrument if the primarily

liable party dishonors the instrument and the following three conditions are met: Presentment Dishonor Notice of dishonor Accommodation parties: An accommodation party is one who signs an instrument to provide credit for another party who has also signed the instrument. Unauthorized signature: If a signature to a negotiable instrument is unauthorized, this unauthorized signature will not impose liability to the named party. Negligence Imposter rule Fictitious-payee rule Warranty Liability Transfer warranty: When a party transfers an instrument to another party for consideration, the transferring party makes certain promises or warranties regarding the instrument and the transfer itself. Presentment warranty: When a party properly presents an instrument for acceptance, that party makes certain promises regarding the instrument and the party who is entitled to payment. Avoiding Liability for Negotiable Instruments Defenses to liability: The arguments for why a party should not be held liable for an instrument include Real (universal) defenses. Personal defenses. Discharge of liability: Release from liability can occur through Discharge by payment or tender of payment. Discharge by cancellation or renunciation. Discharge by reacquisition. Discharge by impairment of recourse. Discharge by impairment of collateral.

Point/Counterpoint Should Holder-in-Due-Course Laws Be Revised? YES NO While measures have been taken to reduce the potential abuse of the holder-in-due-course status, certain industries are still able to use it en masse to take unfair advantage of consumers, and the current justifications keeping the current statutes in place are outdated. When the holder-in-due-course rules were enacted, the use of negotiable instruments by consumers to make purchases was quite common (primarily in the form of checks). However, as modern consumers have largely abandoned checks in favor of bank lines of credit, the use of negotiable instruments has plummeted. Thus, the current laws are designed to protect a certain consumer behavior that has become obsolete. While the holder-in-due-course statutes have become less useful to consumers, they have become far more useful to certain industries, especially the subprime mortgage industry, for getting away with predatory loan practices. The use of assignees in the subprime loan market, which is a market where the buyer and seller are rarely on equal footing, has skyrocketed over the past two decades. The scenario in predatory subprime mortgage loans often involves targeting weak or desperate consumers (especially the elderly and those living in low-income areas), convincing

them to agree to a loan with exorbitant interest and unfair terms, and assigning the promissory note to a third party that has far more leverage and means to mitigate the risk than the consumer. The current holder-in-due-course laws protect these practices by granting immunities to assignees and severely limiting the options of recourse for consumers. The laws governing holder-in-due-course status work as intended and have many benefits that could be lost upon revision of these statutes. First, holder-in-due-course laws encourage commercial transactions by providing protections for assignees and instilling confidence in the negotiable instruments market. These factors make negotiable instruments more liquid and exchangeable as if they were cash. This increased liquidity and confidence can lead to benefits for society as well as the commercial realm. The holder-in-due-course status encourages third parties to buy notes, which can make obtaining credit cheaper and/or easier. For example, small banks have more incentive to make more home loans if they can resell their borrowers' promissory notes to investors or other banks. These third parties are more willing to buy the notes if the holder-in-due-course status means they can do so free from defenses. Thus, more people are able to obtain and use credit to better their lives with the current holder-in-due-course statutes.

Questions & Problems Explain the rationale for the following statement: "The purpose of holder-in-due-course status is to encourage parties to engage in financial transactions." What are the requirements of holder-in-due-course status? What is the distinction between primary liability and secondary liability for a signed negotiable instrument? Evaluate the following statement: "A party can never be held liable for a negotiable instrument if he or she did not sign the check." What are the similarities and differences between transfer and presentment warranties? How are real defenses different from personal defenses to liability for a negotiable instrument? Brent Bentrim purchased a house by obtaining a loan from Bank of America. In 2002, Bentrim borrowed $182,700 from First Union National Bank, executing a mortgage and note in First Union's favor during the process. Bentrim used the loan to pay off the first loan to Bank of America in full. First Union subsequently merged with Wachovia Bank in 2006. Wachovia sold its interests in the note to The Money Store Service Corporation which was a subsidiary of The Money Store, LLC. This LLC was in turn a subsidiary of Wachovia Bank. In 2011, Bentrim filed a complaint against Wells Fargo, who allegedly held the note after merging with Wachovia in 2009. Wells Fargo in turn counterclaimed for foreclosure on the balance of the note. According to

the court, Wachovia gained holder-in-due-course status after because of the sale of the note to a subsidiary of its subsidiary, The Money Store Corp. Do you think this is what lawmakers had in mind when they created this doctrine? Since Wachovia held HDC status on the promissory note from Bentrim, would Wells Fargo also be considered a holder in due course after gaining the note through its merger with Wachovia? How did the court decide? Source: Bentrim v. Wells Fargo Bank, NA, SC: Court of Appeals (2017). In 2006, Wachovia Corporation merged with World Savings Bank, FSB's parent company and the successor company became known as Wachovia Mortgage, FSB. In 2008, Wells Fargo & Company acquired Wachovia and a year later, merged to become Wells Fargo Bank, N.A. Wells Fargo Bank is the appellee in this case. In 2004, Alice Vogel executed a promissory note with World Savings Bank. Vogel also executed a mortgage agreement with World Savings Bank. Vogel eventually defaulted on the loan and Wells Fargo filed a complaint seeking foreclosure. During the cross-examination of Wells Fargo's vice president of loan documentation, it came to light that there were two endorsements on the last page of the original note. The first was a special endorsement from World Savings Bank to Fannie Mae, and the second was a blank endorsement. Neither endorsement was dated. Considering the series of mergers that led to Wells Fargo holding the note, what are the implications of the fact that there were two undated endorsements on the back of the note executed by Vogel? Source: Vogel v. Wells Fargo Bank, NA, 192 So. 3d 714 (2016). In 2005, Lawrence Don, Victor Lissiak, and J. Randolph Light formed The Stretford at the Cascades Limited Partnership to develop a high rise condominium in Tyler, Texas. Between 2005 and 2007, Stillwater National Bank (SNB) loaned over $20 million to The Stretford. In 2008, SNB made a number of individual loans to the partners totaling $2.5 million. The loans were consolidated into one promissory note that year. SNB transferred the note to SW Loan OO, L.P. in 2011. After failing to reach an agreement to restructure their obligation, Light and Stretford filed actions against SNB and SW to gain declaratory judgment. SW subsequently filed a cross-claim against Lissiak to recover the balance on the $2.5 million promissory note. While Light, Stretford, and SNB managed to settle, SW and Lissiak were still embroiled in the lawsuit. The trial court eventually granted summary judgment in favor of SW and ordered that SW recover over $3 million. Lissiak appealed, arguing, among others, that there is a question of authenticity concerning his signature on the 2008 $2.5 million promissory note. As evidence, Lissiak submitted an affidavit where he stated he believed the note is not valid and that he does not recall signing the promissory note. Do you think this is enough evidence to call into

question the signature on the promissory note? What kind of evidence would be needed? Source: Lissiak v. SW LOAN OO, LP, 499 SW 3d 481 (2016). Mary Lodge was one of eight African American first-time homebuyers who filed an action against United Homes LLC, lenders, appraisers, lawyers, and others, alleging that the defendants conspired to sell them overpriced, defective homes, financed with predatory loans. Page 434In 2002, Lodge purchased a home at 249 Halsey Street from United Homes for $419,000. Lodge took out two mortgage loans with Olympia Mortgage Company after being told that she would be able to pay for the mortgage by renting out rooms. After moving into the new house, Lodge found out that the house was in a state of disrepair; the floor of the house was rotten, the basement flooded during rain, and the house was not insulated. Wachovia Bank, which had bought Lodge's first mortgage from Olympia, sought a summary judgment against Lodge's claims against the enforceability of the mortgage based on the defense that Wachovia was the holder in due course. However, the court found that Wachovia did not acquire the mortgage in good faith and denied Wachovia's motion for summary judgment. The NYUCC defines "good faith" as "honesty in fact in the conduct or transaction concerned." Is this an objective or subjective definition of "good faith"? What evidence would the judge need to dismiss Wachovia's motion for summary judgment using the NYUCC definition of "good faith"? Source: Barkley v. Olympia Mortgage Company, 557 Fed. Appx. 22 (2014). We meet Robert Triffin once again. On October 2012, the Child Support Enforcement Administration ("CSEA") issued a check in the amount of $544 to Rashad Jemal Christmas. The face of the check had a notation which stated "VOID AFTER 90 DAYS." Christmas cashed the check at Friendly Cash Checking Corporation ("Friendly") four days after being issued the check. Friendly later tendered the check to Bank of America for cashing. However, Friendly waited 131 days after the check was issued to cash the check. The check was subsequently dishonored by Bank of America and marked "REFER TO MAKER." Triffin enters the picture here. On March 13, 2013, Triffin acquired the dishonored check from Friendly for value. Triffin then filed a complaint against CSEA and Christmas. Judgment was awarded against CSEA and Christmas for $756.41. CSEA then filed a motion to vacate the judgment on the grounds that Triffin was not a holder in due course because he did not acquire the check in good faith. Despite the fact that the court agreed with this claim, the judge maintained that Triffin was a holder in due course because of the shelter principle. When Christmas cashed the check at Friendly, he transferred his rights as holder in due course to Friendly, who then transferred the rights to Triffin. The court dismissed CSEA's motion to vacate judgment. Do you agree with the court decision? Is

Triffin abusing the shelter principle to make money off of dishonored checks? Are the benefits of encouraging the marketability of instrument of negotiation worth the potential issues created by the shelter principle? Source: Robert J. Triffin v. Maryland Child Support Enforcement Administration, and Rashad Jemal Christmas, 436 N.J. Super. 621 (2014). In this strange case, Albertson has already been convicted of passing checks that were ultimately dishonored because of insufficient funds in Albertson's checking account. Both Albertson and a witness claim that the person to whom the checks were issued had an agreement with Albertson that the drawee would hold on to the checks until Albertson had sufficient funds to cover the checks. The drawee was a used-car dealer who admitted in court that he had hold-check agreements with others but could not recall whether he had one with Albertson. Naturally, Albertson does not want to be liable for the checks that were later dishonored. Given the principles of law you learned in this chapter, what facts would need to be true for Albertson to have a reasonable argument on his behalf? Source: Albertson v. State, 2013 WL 3233378 (Md. App. 2013). Starting in November 15, 2010, Kenneth Flaska, a former partner to Dawda, Mann, Mulcahy & Sadler, P.L.C., defrauded the law firm by presenting and depositing checks drawn on the law firm's IOLTA account into Flaska's personal bank account at Bank of America. Flaska deposited nine checks over the course of three years, totaling $529,676.50. All nine of the checks were drawn from the law firm's IOLTA account and were payable on their face to "Bank of America." In order to recoup their losses, the law firm sued Bank of America, alleging that Bank of America did not make an inquiry into the checks before depositing them, therefore breaking the common law "duty of inquiry." The defendant contended that since the law firm is not one of its customers, it did not owe the law firm any duty. Bank of America also contended that it held the checks as a holder in due course. The judge rules in favor of the law firm, finding the holder in due course defense as inapplicable. Why did the judge decide that the holder in due course defense is inapplicable? Were there any irregularities in the checks which should have alerted Bank of America to possible fraud? Source: Dawda, Mann, Mulcahy & Sadler, P.L.C. v. Bank of America, N.A., 85 U.C.C. Rep. Serv. 2d (Callaghan) 282 (2014). Page 435A Chapter 7 bankruptcy trustee is filing an action to recover funds from the wife of a debtor. The wife signed a debtor's instrument in which her husband borrowed funds to construct utility barns and fencing necessary for his horse-raising business. The debtor and his wife used the property on which the horse-raising facilities were built as their residence. The purchase of the materials to construct the barns and fence was not made with any intention

of increasing the value of their residential property. What additional information would you need to determine whether the wife was an accommodation party for purposes of determining liability regarding the debt instrument that she signed? Source: In re Simpson, 474 B.R. 656 (Bkrtcy. S.D. Ind. 2012).

Part 5 Creditors' Rights and Bankruptcy CHAPTER 19 Secured Transactions and Bankruptcy Page 436 CASE OPENER A Commercially Reasonable Sale? In 2011, Airpro Mobile Air entered into a $1,705,649.70 loan agreement with Prosperity Bank's predecessor. The loan was secured by Airpro's assets, including its inventory, parts, accounts, equipment, and general intangibles. In 2016, Airpro leased real property from H&H Properties. Airpro failed to pay rent, and H&H locked Airpro out of the premises. The collateral for Prosperity's loan was locked in the premises. Airpro later defaulted on its loan with Prosperity, and Prosperity sought to foreclose on the collateral. H&H maintained it had a superior lien and denied Prosperity access to the collateral. Prosperity sued H&H for possession of the collateral and sought $1,357,827.00 in damages. While Prosperity's lawsuit was pending, it sold the collateral by private sale to the only bidder, Phoenix Mobile Air, for $17,500, which Prosperity credited to the balance due on Airpro's loan. A year later, Prosperity and H&H settled their lawsuit for $30,000, which Prosperity credited to Airpro's balance. Prosperity then sued Airpro for the deficiency of $1,356,493.79, but Airpro countered the collateral's sale was commercially unreasonable.1 If you were the judge deciding this case, would you grant Prosperity the full amount of the deficiency? If you were the manager of Prosperity, what steps would you take to secure the rights of your company to Airpro's assets? LEARNING OBJECTIVES LO 19-1 List the important definitions associated with secured transactions. LO 19-2 Describe how secured interests are created. LO 19-3 Describe how secured interests are perfected. LO 19-4 Recall the scope of a security interest. LO 19-5 Explain how priority disputes are handled. LO 19-6 Define default. LO 19-7 Identify the goals of the Bankruptcy Act. LO 19-8 Describe the specific types of relief available through bankruptcy. LO 19-9 Explain how various creditors' claims are prioritized in bankruptcy. Page 437 The agreement made between Airpro Mobile Air and Prosperity Bank regarding Airpro's assets is a common component of business transactions. Such agreements are called secured transactions. A secured transaction is a transaction in which the payment of a debt is guaranteed by personal property the debtor owns. In the Case Opener, Airpro Mobile Air guaranteed that it loan by giving Prosperity Bank

rights to its inventory, parts, accounts, equipment, and intangibles, including the right to sell them upon repossession. In contrast, a creditor that does not have a secured interest must file a lawsuit, obtain a judgment, and execute on the judgment to recover money for an unpaid debt. Article 9 of the Uniform Commercial Code (UCC) governs secured transactions in personal property (as opposed to real property). Thus, throughout the chapter, we refer to Article 9 of the UCC. As of 2014, with some variation, all states had enacted Article 9. Thus, although the law governing secured transactions is state law, the universal adoption of Article 9 permits us to discuss laws regarding secured transactions across state lines.

Important Definitions Associated with Secured Transactions LO 19-1 List the important definitions associated with secured transactions. It is important to understand the definitions of the terms used in secured transactions to understand how such transactions are created. These definitions generally come from the UCC's definitions of the terms: A secured interest is an "interest in personal property or fixtures which secures payment or performance of an obligation" [UCC 1-201(37)]. Suppose Best Buy sells you a laptop on credit. Best Buy retains a secured interest in the laptop, which means that the store can repossess the laptop if you fail to make payments. A secured party is the person or party that holds the interest in the secured property. Thus, in the preceding example, Best Buy is the secured party. The secured party is also known as the secured creditor. A debtor is the person or party that has an obligation to the secured party. You, the laptop owner, are the debtor because you have an obligation to make payments. A security agreement is the agreement in which the debtor gives the secured interest to the secured party. Thus, when you made the agreement with Best Buy, you created a security agreement. Collateral is the property that is subject to the security interest. In the Best Buy example, the laptop is the collateral. Collateral may include goods (consumer goods, farm products, inventory, and equipment), indispensable paper (documents of title, negotiable instruments, and chattel paper), intangibles (accounts, goodwill, and literary rights), and proceeds.

Creation of Secured Interests LO 19-2 Describe how secured interests are created. How does a creditor become a secured party? To become a secured party, the creditor must gain a security interest in the collateral of the debtor. There are three criteria for creating the security interest: The two

parties create a security agreement and either (a) there is a record of the security agreement (usually a written agreement that describes the collateral and is signed by the debtor) or (b) the secured party is in possession of the collateral. The secured party must give value to get the security agreement. The debtor has a right in or to the collateral [UCC 9-203(b)]. Once these three criteria are met, the secured party's rights attach to the collateral. When attachment occurs, the creditor becomes a secured party with an interest in the collateral. Written Agreement The written agreement, often referred to as the security agreement, must be signed by the debtor. Moreover, the agreement must describe the collateral. The description must be accurate and detailed enough to identify the collateral. For example, in a description of a laptop that is serving as collateral, the serial number of the laptop might be listed in the written agreement. Let's revisit the Case Opener. The security agreement between Airpro Mobile Air and Prosperity Bank most likely included the following: (1) a statement that Airpro Mobile Air owned the assets it was pledging as collateral; (2) a statement that Prosperity Bank was retaining a security interest in these assets; (3) a description of the assets; (4) the amount of the loan and a payment schedule; and (5) a description of the process to be utilized in the event of Airpro Mobile Air's default and the subsequent possession of the assets by Prosperity Bank. It is important for the collateral to be described clearly in the written agreement because the creditor could otherwise lose its rights to the collateral. Value The secured party must give value. What exactly does it mean to give value? According to the UCC, value is consideration. Thus, in the Case Opener, the use of the automobile was considered the value that Prosperity Bank gave to Airpro Mobile Air. Alternatively, suppose you receive a loan from a company. The money is the value given by the company, the secured party. Debtor Rights in the Collateral The final criterion necessary for the attachment of the security interest is the debtor's rights in the collateral. Airpro Mobile Air, the borrower, had a legal right to the business assets (the collateral) after it signed the loan agreement. Purchase-Money Security Interest Now that we have discussed the criteria necessary for the creation of a security interest, we briefly consider one specific type of security interest, the purchase-money security interest (PMSI), which is formed when a debtor uses borrowed money from the secured party to buy the collateral. According to the UCC, a PMSI exists when a security interest is retained or taken by (1) the seller of the collateral to secure part or all of the purchase price or (2) a person who gives something of value to the debtor so that the debtor can gain rights to or use of the collateral [UCC 9-103]. In our laptop example, you

bought the laptop on credit from Best Buy. Best Buy extended credit to you for the entire purchase price of the laptop. In other words, Best Buy is lending you the money to buy the laptop. Because the laptop is the collateral, Best Buy has a PMSI.

Perfected Security Interest LO 19-3 Describe how secured interests are perfected. Suppose that you borrow money from a bank and the bank has a secured interest in your wedding ring. You are supposed to make monthly payments to the bank, but you lose your job and cannot make the payments. When you fail to make these payments, you default on the loan. Because the bank has a secured interest, it can repossess your ring. But suppose you also borrowed money from another creditor, your boss, and you used your ring as collateral for that transaction as well. Your boss was unaware that you used the ring as collateral for your bank loan. Both your boss and your bank have an interest in your ring. Who gets the ring? The party that perfects its interest in the ring will have first claim. When a party perfects its interest in collateral, it is legally protecting its claim to the collateral. Perfection is a series of legal steps a secured party takes to protect its right in the collateral from other creditors who want their debts satisfied through the same collateral. In the following sections, we consider the various methods of perfection. Perfection by Filing The most common way to perfect an interest is to file a financing statement with a state agency. According to the UCC, a financing statement should list the names and addresses of all the parties involved, a description of the collateral, and the signature of the debtor [UCC 9-502]. First, the names and addresses of the statement are important elements because someone looking for the financing statement may want to contact the secured party or the debtor. Second, the financing statement must be filed under the name of the debtor whether the debtor is an individual, an unincorporated business association, or a corporation. If the statement is filed under an incorrect name, the perfection is likely not effective. Third, the financing statement must include a description of the collateral. The purpose of including a description of the collateral is to inform other potential parties who might want to lend money to the debtor. The description of the collateral may be replicated from the description of the collateral in the security agreement. Once the financing statement is filed, the statement becomes public knowledge. Parties considering making a loan to another party are expected to search for notification of secured interests. Consequently, if you ask to borrow money from your boss, your boss should check with state agencies to ensure that you have not already used your ring

as collateral. If your boss discovers that your bank has perfected its interest in your ring, your boss should not agree to loan you money with the ring as your collateral because the bank’s perfection of the security interest means that the ring will go directly to the bank. Your boss would have a claim against the ring only as an unsecured creditor. Place and Duration of Filing Suppose you need to file a financing statement. Where should you file? For how long is the filing effective? The place of filing depends on whether the debtor is an individual or a business. If the debtor is an individual, the secured party files the financing statement in the state in which the debtor resides. The actual place of filing differs from state to state. Sometimes the statements are filed with the secretary of state. Alternatively, the statements might be filed with the county clerk. Each state must establish a central filing office. Once you have filed the financing statement with the correct agency, for how long is the statement valid? Under the UCC, the statement is valid for five years [UCC 9-515]. After five years, the statement expires, and the security interest is not protected. However, within six months of the expiration date of the financing statement, the secured party can file a continuation statement, which is valid for another five years. Perfection by Possession Sometimes a debtor gives a creditor the collateral to hold until the loan is paid off. For example, suppose that you borrow money from a bank and give the bank your diamond necklace to hold until you pay back the loan. The transfer of collateral to the secured party for the purpose of perfection is called a pledge. When the bank takes possession of the necklace, it has perfected its interest without filing a financing statement. Once you pay off the loan, the necklace is returned to you. Page 440 Several advantages are associated with perfection by possession. First, a secured party does not have to file a financing statement. In fact, the parties do not even have to create a written security agreement. Second, there is little chance that another party will loan money to the debtor relying on the collateral that another secured party possesses. Third, if the debtor defaults on the loan, the secured party already has possession of the collateral, so no difficulties are associated with repossession. Despite the many advantages of perfection by possession, it is often impractical because the debtor cannot benefit from the use of the collateral. For example, if you get a loan from a bank to purchase farm equipment, you likely need the farm equipment to produce crops that will enable you to make payments on the loan. Certain types of collateral must be perfected through possession. These types of collateral include instruments—writings that serve as evidence of rights to payment of money, such as certificates of deposit—and stocks and bonds. Automatic Perfection If a retailer had to file a financing statement every time

it sold a laptop, a wide-screen television, or a washer and dryer on credit, the retailer would do nothing but file statements. Moreover, it does not make sense for the retailer to possess the collateral. Thus, when a creditor sells a consumer good to a debtor on a credit basis or a creditor extends a loan to a debtor for the purchase of a consumer good, the security interest in the good perfects automatically. Under the UCC, a consumer good is a good used or bought for use primarily for personal, family, or household purposes [UCC 9-102(23)]. Thus, if an item is purchased for business use, the security interest would not perfect automatically; the secured party would have to file a financing statement. Perfection of Movable Collateral According to the UCC, a security interest in collateral that has been perfected in one state will generally transfer to another state for a period of four months from the date that the property is brought into the state. The secured party may reperfect the interest in the new state. However, if the interest is not reperfected, the secured party may lose its protection. Perfection of Security Interests in Automobiles and Boats We have now discussed various methods of perfection: perfection by filing, perfection by possession, automatic possession, and perfection of movable collateral. Exhibit 19-1 provides a summary of the methods of perfection. None of these methods apply to perfection of automobiles and boats. Each state has created special laws that pertain to perfection of motor vehicles. Exhibit 19-1Summary of Methods of Perfection by Type of Collateral Perfection by Filing Chattel paper: Writing that indicates the debtor’s monetary obligation as well as a secured interest Documents of title: Papers that demonstrate the owner’s possession of the goods (e.g., warehouse receipts) Accounts: Rights to payments for goods sold or leased General intangibles: Trademarks, copyrights, patents Equipment: Goods purchased primarily for business use Farm products: Products of livestock or crops Inventory: Goods held for sale or lease Fixtures: Goods that have become attached to real estate Automatic Perfection Purchase-money security interests in consumer goods Perfection by Possession Chattel paper Documents of title Instruments (stocks, bonds, checks) Pawnbroker holding jewelry or other valuables Perfection of Interests in Motor Vehicles Notation of secured interest on certificate of title Almost every state requires a certificate of title for any motor vehicle. Perfection of a security interest in a motor vehicle occurs when the secured party makes a notation of this interest on the certificate of title. The rationale for noting the interest on the title is that the title will follow the car owner everywhere. Thus, the title would be the best place to note a secured interest. If a creditor examines a title and discovers no notation of a secured interest in the

vehicle, the creditor can assume that no other creditors have a secured interest in the vehicle.

The Scope of a Security Interest LO 19-4 Recall the scope of a security interest. Generally, once a secured party perfects its interest in collateral, the perfection is effective until the collateral is sold, exchanged, or transferred. Our examination of security interests to this point has been concerned with property the debtor currently possesses. However, a security interest can also apply to personal property that is not yet in the debtor's possession. Page 441 After-Acquired Property You borrow $60,000 from your bank to start an electronics store. However, you have recently graduated from college and have only your car, valued at $3,500, as collateral. The bank will take a security interest in your car, but it will also take a security interest in the materials that you will purchase to open your store. For example, you will need to create an inventory of televisions, computers, and stereos, which are after-acquired property, property acquired by the debtor after the security agreement is made. After-acquired property can be inventory, livestock, equipment, or almost any other kind of property. Under the UCC, a party may agree, through a clause in the security agreement, that the security interest will attach to after-acquired property. Whenever the debtor purchases new equipment or goods, the security interest is attached to the new good. Thus, whenever you buy a television to sell in your store, the bank's security interest in the television will attach. Proceeds When a debtor sells collateral, they receive proceeds, something that is exchanged for the collateral. The secured party automatically has an interest in the proceeds. Why? If you use a good as collateral for a bank loan and then sell that good, the bank has nothing to continue to secure its loan. Consequently, the security interest in the good also applies to the proceeds from the good. Under the UCC, the secured party's interest in the proceeds lasts only 10 days after the debtor receives the proceeds. At that time, the secured party will typically need to file a new financing statement. The parties may also agree in the security agreement that there will be extended coverage of interest in the proceeds.

Termination of a Security Interest Suppose that, rather than defaulting on the loan, Airpro Mobile Air paid Prosperity Bank the full amount as required under

the agreement. If a secured party has filed a financing statement and the debtor has repaid the secured party, the secured party must file a termination statement with the filing office. A termination statement is an amendment to a financing statement, which provides that the debtor has no further obligation to the secured party [UCC 9-513(a)].

Priority Disputes LO 19-5 Explain how priority disputes are handled. We have spent much time discussing the perfection of a security interest. Why? Remember, perfection of an interest is supposed to serve as protection of the secured party's interest in collateral from other creditors. In this section, we consider various conflicts between creditors who claim interest in the same collateral. A conflict may arise in many circumstances; however, priority disputes are most likely to arise when a debtor files for bankruptcy. Secured Versus Unsecured Creditors Generally, secured parties have priority over unsecured creditors. Thus, if two parties provide a loan based on the same collateral, the party with the secured interest will have priority in repossessing the collateral over the party with the unsecured interest. This priority to the collateral does not depend on the perfection of a secured interest. Rather, the priority depends on the attachment of the secured interest. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let's say, in the Case Opener, that AirPro Mobile Air used its inventory, parts, accounts, equipment, and general intangibles as collateral not only with Prosperity Bank but also with another bank from whom it received a loan. Let's say that Prosperity Bank is unsecured, and the other bank is secured. Who would be able to claim the collateral if AirPro Mobile Air defaulted on both loans? Secured Versus Secured Creditors Who has priority to the collateral when both parties are secured creditors? If both parties are secured, the determination of priority to collateral moves to considerations of time and perfection. The party that perfected its interest first will have priority in claim to the collateral [UCC 9-317]. Finally, if neither party has perfected its security interest, the party that attached its security interest first will have first claim to the collateral. Exhibit 19-2 provides a summary of the priority of creditors' claims to collateral. Exhibit 19-2Summary of Priority of Creditors' Claims to Collateral DISPUTE PREVAILING PARTY Secured versus unsecured creditor Secured creditor Secured perfected creditor versus secured unperfected creditor Secured perfected creditor Secured perfected creditor versus secured perfected creditor Party who perfected its interest first Secured unperfected creditor versus secured unperfected creditor Party who attached its interest first PMSI Conflicts There is an exception to these

priority rules. Generally, if a PMSI is involved, the perfected PMSI will almost always have priority over other claims to collateral. The rules regarding PMSIs depend on whether the collateral is inventory or noninventory. First, if the PMSI is in inventory, the perfected PMSI has priority over a previously perfected non-PMSI if the following two conditions are met: (1) The PMSI party perfects its interest before or at the same time that the debtor receives his inventory; and (2) the PMSI party checks for previous secured interests and gives written notice to the holders of any conflicting security interest [UCC 9-324(b)]. What happens if the collateral is not inventory? If the PMSI is in noninventory collateral, the PMSI has priority over any other secured perfected interests as long as the PMSI is perfected within 20 days of the debtor's possession of the collateral [UCC 9-324(a)]. Page 443 Secured Party versus Buyer If a debtor sells collateral in which a secured party has an interest, the security interest generally remains in effect. Suppose you obtain a loan from a bank and use your boat as collateral. You need more money, so you sell your boat. The bank's secured interest in the boat remains with the boat. If you default on the loan, the bank can seize the boat from the buyer. However, the UCC provides some exceptions to this general rule. Buyers in the Ordinary Course of Business A buyer in the ordinary course of business is a person who routinely buys goods in good faith from a person who routinely sells such goods. Under the UCC, a buyer in the ordinary course of business can take the goods free of any security interest created by the seller of the goods even if the security interest is perfected [UCC 9-320(a)]. What is the rationale for this rule? Asking buyers to determine whether a security interest in inventory exists is burdensome. Thus, the purpose of this rule is to encourage commerce. For example, if your company buys products from an electronics store in the ordinary course of business, you can take possession of these products free of any security interest created by the party who originally sold the products to the electronics store. Buyers of Consumer Goods Suppose you buy a digital camera for $800 on credit from Best Buy. Best Buy has a security agreement for a PMSI in the digital camera. (Remember, a PMSI in a consumer good perfects automatically.) However, you discover that you do not have enough money to pay your rent. Consequently, you sell your digital camera to your neighbor, who is unaware of Best Buy's secured interest in the camera. Can Best Buy repossess the camera? Under the UCC, as long as the buyer is not aware of the security interest, purchases the good for his or her personal use, and purchases the good before the secured party files a financial statement, the buyer obtains the good free of the security interest [UCC 9-320(b)]. Even though the secured party's interest perfects automatically, the secured party must have

filed a financial statement to repossess a consumer good from another buyer. Buyers of Chattel Paper and Instruments If a buyer purchases chattel paper, a writing that indicates both a monetary obligation and a security interest in specific goods, or an instrument, a writing that demonstrates a right to payment of money, in the ordinary course of business, the buyer can obtain the good free of any security interest. The buyer must typically be unaware of the security interest in the good. Why is there an exception for buyers of chattel paper and instruments? Both chattel paper and instruments are easily transferable. Consequently, the UCC provides that these forms of collateral can be sold to a buyer free of the secured party’s interest. Sometimes, the issue with a secured creditor is not the simple repossession of collateral but the collection of monies relating to the collateral. The following Case Nugget examines whether a commercial tort claim arising from the debtor's operation of its business related to the collateral such that it belonged to the secured creditor. CASE Nugget Rights of a Secured Party In re: Puerto Rico Hospital Supply, Inc. v. U.S. District Court for the District of Puerto Rico 2020 WL 1672530 (D.P.R. 2020) In April 2017, Puerto Rico Hospital Supply, Inc. (PRHS) entered into a credit agreement with Banco Santander Puerto Rico (Santander) pursuant to which Santander extended credit to PRHS for $32 million. PRHS executed a security agreement granting Santander a security interest in its assets, including its inventory, accounts receivable, general intangibles such as contract rights, and any proceeds thereof. Santander perfected its security interest by filing a financing statement. In May 2019, an arbitration panel entered an award in favor of PRHS and against Johnson & Johnson finding that Johnson & Johnson had unjustly terminated a 2005 distribution agreement in violation of Puerto Rico’s Dealer’s Contract Act. The arbitration panel awarded PRHS $1.1 million in damages, which was confirmed by the U.S. District Court for the District of Puerto Rico. Santander sought a declaration from the court as to the extent of its lien over the Johnson & Johnson award based upon its secured interest in PRHS’s contract rights and general intangibles. The court concluded that the damages award were proceeds from a commercial tort claim pursuant to applicable Puerto Rican law and were not clearly identified and described in the security agreement. The description of the collateral in the security agreement was broad and comprehensive and included contract rights, general intangibles, and proceeds. Such broad descriptions would ordinarily be adequate, but Puerto Rico’s version of the Uniform Commercial Code required clear identification and specific description of commercial tort claims in order to create a valid security interest. Furthermore, the commercial tort claim against Johnson & Johnson did not exist at the time of

the creation of the security interest. The court concluded that the award was not related to the collateral and, thus, Santander did not have a right to the recovery of the funds resulting from the Johnson & Johnson arbitration.

Default LO 19-6 Define default. Generally, when a debtor fails to make payments on a loan or declares bankruptcy, the debtor has defaulted on the loan. However, the UCC does not define default. Consequently, each security agreement provides a specific definition of what is considered a default. Moreover, each agreement determines the procedures and consequences that occur in the event of default. Because the creditor is usually in a better bargaining position, the creditor usually determines the definition of default. What are a secured party's remedies to recover its money when a debtor defaults on a loan? The secured party can (1) take possession of the collateral or (2) ignore its rights in the collateral and proceed to judgment. However, the party is not limited to just one of these remedies. If one method is unsuccessful, the party can attempt to pursue the other method. Note that these remedies are limited if the debtor has filed for bankruptcy. Taking Possession of the Collateral If a debtor defaults on a loan, the secured party can take possession of the collateral [UCC 9-609]. Although the secured party may act without any court order to retain possession of the property, the secured party may not breach the peace in repossessing the property. What exactly is breaching the peace? The UCC does not define the phrase. Generally, if the secured party can repossess the collateral without using force or committing trespass, the action is not a breach of the peace. If the secured party is unable to repossess the property without breaching the peace, the party will file suit against the debtor to obtain a court order for the debtor to turn over the property. Consider Case 19-1, in which the debtor was injured during the creditor's attempt to repossess the collateral after the occurrence of a default. CASE 19-1 PRICE AUTO SALES, INC. V. SANDERS Texas Court of Appeals 2012 Tex. App. LEXIS 7274 (Tex. App. 2012) FACTS: Price Auto hired David Chad Kuykendall, doing business as Chad's Auto Recovery, to repossess a 1998 Cadillac DeVille owned by Carlous Sanders, who was in default on his motor vehicle retail installment sales contract. On May 11, 2009, Kuykendall went to the apartment complex where Sanders lived and located the Cadillac in a parking space facing Sanders' apartment. Using a key provided by Price Auto, Kuykendall entered the car and started the engine. Sanders testified that he was descending the stairs from his

apartment when he first heard his car's ignition and then saw a person inside his car backing the vehicle out of its parking space. Believing his car to be in the process of being stolen, Sanders approached the vehicle. As Sanders approached the driver's side door, the car moved onto his foot, causing him to fall to the ground and suffer a head injury. The car then rolled over Sanders' leg as it exited the parking lot. Kuykendall did not stop to render aid and exited the apartment complex. Kuykendall proceeded to attach the vehicle to his tow truck and deliver it to Price Auto. ISSUE: Sanders sued Price Auto and Kuykendall for his injuries, alleging that they were liable for the breach of the peace that occurred during the repossession. Sanders was awarded $20,281.39 in damages at trial. Price Auto appealed on the basis that the repossession was complete before any alleged breach of the peace occurred. REASONING: The court agreed with Sanders and upheld the trial court's award of damages. The court held that a secured party may take possession of collateral after a default without judicial process if it proceeds without breach of the peace. This rule recognizes that society's interest in preserving the peace is more important than a secured party's right to possession. When a secured party chooses to pursue a nonjudicial repossession, it assumes the risk that a breach of the peace might occur. In this case, the evidence did not conclusively establish that the repossession was complete before Sanders suffered his head and leg injuries. Thus, Price Auto did not demonstrate reversible error in connection with the trial court's determination that a breach of the peace occurred in the process of the repossession. In reaching this conclusion, the court cited two cases. In the first case, the recovery agent towed the vehicle out of sight of the debtor's premises and subsequently discovered the debtor's two children inside the vehicle. He immediately returned to the debtor's home and returned the vehicle and children. There was no breach of the peace in this case as the recovery agent removed the vehicle from a public street without confrontation or trespassing on the debtor's premises and immediately terminated repossession efforts and returned the children upon learning of their presence. By contrast, in the second case, the vehicle's owner mistook the recovery agent for a car thief and, along with a coworker, attempted to stop her from leaving with the vehicle. The recovery agent struck the coworker and seriously injured him while driving away from the premises. In this case, the court held that the owner had a right to object to the attempted repossession as it was no longer peaceable. This case was very similar to the facts concerning Price Auto's repossession of Sanders' vehicle. DECISION AND REMEDY: The court held that the evidence presented at trial was sufficient to support the trial court's decision and thus affirmed the

judgment against Price Auto. SIGNIFICANCE OF THE CASE: This case illustrates the difficulties creditors may encounter in attempting to repossess collateral upon the occurrence of a default. Although Sanders was in default on his obligations to Price Auto, it was nevertheless required to proceed in a manner to repossess the collateral without breaching the peace. As illustrated in this case, repossession can lead to confrontations which may turn physical and result in injuries to one or both parties. Adding to the complications is the use of recovery agents to perform the actual repossession. The actions of these individuals may be attributable to the secured party, as occurred in this case, and thus care in their selection, utilization, and supervision is important. CRITICAL THINKING What is the argument that this judge is making? How good are his reasons? Is there any information that you feel he left out that would help you come to a conclusion on the issue presented in this case? ETHICAL DECISION MAKING Return to the materials on ethical decision making. Suppose you were the manager of Price Auto Sales in this situation. How might you have behaved differently if you were following the Golden Rule? Page 445 Generally, the security agreement will state that if the debtor defaults on the loan, the debtor must turn over the collateral in a reasonable time and manner. If the debtor refuses to turn over the property, the secured party will typically hire a repossession company to obtain the collateral. Once the secured party has possession of the collateral, the party can choose to retain or dispose of the collateral. Page 446 Disposition of the Collateral Under the UCC, the secured party can sell, lease, or transfer the collateral in any commercially reasonable method [UCC 9-610]. The secured party may sell the collateral in a private or public sale. Regardless of where the collateral is sold, the secured party must strive to receive the best price for the collateral. Striving to receive the best price is part of the requirement to conduct every aspect of the sale in a commercially reasonable manner. In addition to adhering to the commercial reasonableness requirement, the secured party must also notify the debtor of the sale. Additionally, the secured party must notify any other parties that have secured interests in the collateral. Once the collateral is sold, the proceeds must be paid in the following order: (1) paying the reasonable expenses of retaking and disposing of the collateral (including attorney fees), (2) satisfying the debt of the secured party, and (3) satisfying remaining holders of junior security interests [UCC 9-615(a)]. Retention of the Collateral Instead of disposing of the collateral, the secured party may choose to keep the collateral in full or partial satisfaction of the debt. However, the secured party must notify the debtor of this intent by sending written notice. The debtor has 20 days to object to the secured party’s

retention of the collateral. If the debtor does not object to the retention, the secured party may retain the collateral [UCC 9-620-622]. By retaining the collateral for full satisfaction of debt, the secured party gives up any claim to the debt. In other words, the secured party cannot demand additional money from the debtor. Consequently, if the collateral is not valued at the full amount of the money due to the secured party, the secured party has no right to additional money from the debtor. If the debtor objects to the secured party's retention of the collateral, the secured party must sell or dispose of the collateral. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let's say, in the Case Opener, that Prosperity Bank took AirPro Mobile Air's inventory, parts, accounts, equipment after it defaulted on its payments, and Prosperity Bank decided to keep this property. Is Prosperity Bank free to choose to keep the collateral in satisfaction of the debt? Proceeding to Judgment Another remedy for a defaulted loan is the secured party's rejection of the right in the collateral and the party's filing of a suit against the debtor. The secured party can sue the debtor for the entire amount of the debt. Rather than taking the time to organize the sale of the collateral, the secured party may choose to file suit. In contrast, an unsecured creditor has just one option: to file suit and seek a judgment in the amount of the debt.

Bankruptcy and Reorganization When an entity is unable to pay its debts, bankruptcy law provides various options for the entity to resolve these debts. Bankruptcy remedies are available to individuals, partnerships, and corporations. Generally, a debtor is an entity that owes money to another entity. However, the term debtor is defined differently under each type of bankruptcy remedy; thus, an individual or company that is eligible for one type of bankruptcy might not be eligible for another type of bankruptcy. The remainder of this chapter explains the various bankruptcy remedies available to debtors. We begin with a discussion of the goals of bankruptcy law and an overview of the Bankruptcy Code. Then we consider specific types of bankruptcy relief under the code.

The Bankruptcy Act and Its Goals LO 19-7 Identify the goals of the Bankruptcy Act. There are two general goals of bankruptcy laws. First, bankruptcy laws provide protection to creditors—entities to whom a debtor

owes money. Bankruptcy laws ensure that creditors competing for a debtor's assets are treated equally and receive a fair share of the debtor's assets. Second, bankruptcy laws provide opportunities for debtors to gain a fresh financial start. In summary, bankruptcy law provides an organized method by which insolvent debtors—debtors who cannot pay their debts in a timely fashion—respond to their debts. Bankruptcy law is federal law. Article I, Section 8, of the Constitution states: "The Congress shall have the power . . . to establish . . . uniform laws on the subject of bankruptcies throughout the United States." Congress revised the Bankruptcy Code through the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005. This revision included the most comprehensive changes to bankruptcy law in over 25 years. Title 11 of The United States Code Title 11 of the United States Code (U.S.C.) contains the Bankruptcy Code, which is divided into chapters. Chapters 1, 3, and 5 provide the general definitions and provisions concerning bankruptcy case administration and debtors. These chapters apply to all types of bankruptcy relief. Chapters 7, 9, 11, 12, 13, and 15, briefly described in Exhibit 19-3, create six specific types of bankruptcy proceedings. Exhibit 19-3Types of Bankruptcy Relief by Chapter Chapter 7 Sale of the debtor's assets by a trustee and the distribution of money to creditors Chapter 9 Adjustment of a municipality's debts Chapter 11 Reorganization of the debtor's financial affairs under supervision of the bankruptcy court Chapter 12 Reorganization of a family farmer/fisherman's debts Chapter 13 Reorganization of an individual's debts Chapter 15 Recognition of insolvency proceedings pending in a foreign country and relief for foreign debtors

Bankruptcy Proceedings Most bankruptcy cases share a set of procedures or certain actions that must be taken in every bankruptcy case. These actions are as follows: All bankruptcy cases begin with the filing of a petition for bankruptcy. Once the petition is filed, the court grants an automatic stay for creditor actions against the debtor's estate. In other words, creditors' legal actions against the debtor must cease. The court determines whether an order of relief should be granted. The creditors meet with the debtor. Some type of payment plan is created and approved, usually by the creditors and the court. The payment plan is implemented by actions of the trustee and the debtor. Debts remaining after the plan is implemented are usually discharged.

Specific Types of Relief Available LO 19-8 Describe the specific types of relief available through bankruptcy. Before a debtor files for one specific type of relief, the clerk of court must give the debtor written notice of the other types of relief available. This requirement helps to ensure that the debtor has full information about the bankruptcy process. Under BAPCPA, an individual may not be considered a debtor under any chapter unless, within 180 days prior to filing, they receive credit counseling from a nonprofit budget and credit counseling agency. If the individual does not fulfill the credit-counseling requirement, the bankruptcy court will dismiss the bankruptcy petition—even if the individual faces immediate home foreclosure or wage garnishment. Moreover, BAPCPA attempts to prevent repeat filers from filing one bankruptcy claim after another. If an individual was a debtor in a bankruptcy case that was dismissed within 180 days of the current case, the individual is generally not eligible to be a debtor under Chapters 7, 11, or 13. However, if the previous bankruptcy was completed rather than dismissed, the individual is generally permitted to file for bankruptcy again. If a party completes a Chapter 7 bankruptcy, the party is not permitted to seek a Chapter 7 bankruptcy again for eight years. In the following sections we discuss the main types of relief available, including Chapters 7, 11, 12, and 13 bankruptcies. Chapter 7: Liquidation Proceedings The most familiar type of bankruptcy proceeding is liquidation, which is sometimes called straight bankruptcy. Liquidation occurs when a debtor turns over all assets to a trustee, an individual who takes over administration of the debtor’s estate. Trustees are usually attorneys in private practice who specialize in bankruptcy law. Every Chapter 7 proceeding has a trustee who sells the nonexempt assets and distributes the proceeds of the sale among the creditors. Liquidation provides an organized method of selling the debtor’s property to generate cash to pay creditors. Who is defined as a debtor for liquidation purposes? Under Chapter 7 liquidation proceedings, individuals, partnerships, and corporations are considered debtors. Railroads, insurance companies, banks, savings and loan associations, industrial banks, credit unions, and health maintenance organizations are not eligible for Chapter 7 relief. Petition Filing As is the case with most bankruptcies, liquidation begins when the petition is filed. Under Chapter 7, liquidation may be voluntary or involuntary; thus, a voluntary or involuntary petition is filed. The person filing the petition is also responsible for paying filing fees. Voluntary Liquidation Petition. When the debtor decides to file for bankruptcy, they file a voluntary petition. The debtor must state that he or she understands the other types of bankruptcy relief available and chooses liquidation. Once the petition is filed, all the debtor’s prepetition assets form the bankruptcy estate. Assets that

the debtor gains after filing the petition are generally not part of the bankruptcy estate unless they fall under an exemption. Involuntary Liquidation Petition. If a debtor is not paying debts as they come due, creditors can attempt to force the debtor into bankruptcy by filing an involuntary petition under Chapter 7. By filing the petition, the creditors attempt to force the debtor to surrender their assets so that the proceeds from the sale of the assets may be distributed among the creditors. If the judge believes that creditors are using involuntary liquidation proceedings frivolously, the court may force the creditors to pay the attorney costs, fees of the debtor, and even punitive damages. Page 449 Not everyone can be forced into bankruptcy through Chapter 7. Farmers, ranchers, and nonprofit organizations are examples of debtors that cannot be forced into liquidation. Also, debtors that are ineligible to file for Chapter 7 bankruptcy voluntarily (railroads, insurance companies, banks, savings and loan associations, credit unions, and health maintenance organizations) are excluded from forced bankruptcy. Dismissal of Petition A bankruptcy judge may dismiss a voluntary or involuntary bankruptcy petition. Under BAPCPA, a bankruptcy judge may dismiss a petition for cause. One cause for dismissal is failure of the means test. If an individual’s debt is primarily consumer debt and if the individual’s income is above the median income in their state, the court may presume that the individual is abusing the bankruptcy provisions. However, the individual may continue with the petition under the presumption. Automatic Stay Once a petition, voluntary or involuntary, is filed, the code provides for an automatic stay, or moratorium, for almost all creditor litigation against the debtor. During the stay, creditors cannot bring or continue legal action against the debtor or his property. For example, creditors cannot attempt to repossess property during bankruptcy proceedings. Moreover, if a creditor received a judgment against a debtor prior to the bankruptcy filing, the creditor may not enforce the judgment. There are some exceptions to the stay. First, under BAPCPA, if the debtor was a debtor in a bankruptcy case that was dismissed within a year of the current bankruptcy case filing, the stay automatically terminates 30 days after the current filing. Second, legal actions to determine paternity or to collect child support or alimony payments are not subject to the stay. Third, the court may exclude secured creditors from the stay if they petition the court to show that they do not have adequate protection under the stay. If a creditor is aware of the stay and continues to engage in legal action against the debtor, the code provides that the debtor may recover damages, costs, attorney fees, and possibly even punitive damages. Order of Relief After a bankruptcy petition has been filed, the next step is for the court to determine whether an order

of relief is granted. An order of relief means that bankruptcy relief is ordered; that is, the bankruptcy proceedings can continue. If the filing of the voluntary petition is proper, the petition automatically becomes an order of relief. Similarly, if a debtor does not object to an involuntary bankruptcy, the order of relief is automatic. If the debtor challenges the involuntary petition for bankruptcy, a hearing will be held. At the hearing, the judge generally will grant the order of relief for involuntary bankruptcy if one of two conditions occurs: The debtor is not paying debts as they become due. The custodian took possession of almost all the debtor's property within 120 days before filing the petition. After the court enters the order of relief an interim trustee is selected. A trustee is the person responsible for collecting the debtor's available assets and liquidating the property into cash for the creditors. The interim trustee is responsible for organizing the creditors' meeting. Creditors' Meeting Between 20 and 40 days after the order of relief has been granted, the interim trustee calls a creditors' meeting—a meeting of all the creditors listed in the Chapter 7 required schedule for liquidation. Although the debtor and the interim trustee also attend this meeting, the bankruptcy judge does not attend. If the debtor fails to appear at the meeting, the court may refuse to grant the bankruptcy. The principal purpose of the creditors' meeting is to enable the creditors and trustee to examine the debtor under oath regarding their financial affairs. Creditors want to know more about the way the debtor is handling their assets and property. Moreover, they want to ensure that the debtor is not concealing property. Not only does the trustee ask the debtor questions regarding their financial status, but the trustee also ensures that the debtor is aware of the other forms of bankruptcy relief as well as the consequences of filing for bankruptcy. Page 450 Another important purpose of the creditors' meeting is the election of a permanent trustee. The interim trustee might become the permanent trustee, or the creditors might elect a different one. The creditors elect the trustee because the trustee generally represents the creditors. The Trustee The general duty of the trustee is to collect the debtor's available assets (i.e., the debtor's prefiling assets) and to liquidate the property to cash that will be distributed among the creditors. Thus, the trustee takes possession of the debtor's property and has it appraised. Moreover, the trustee examines the debtor's records and might even temporarily take over the debtor's business. If someone else holds the debtor's property, the trustee has the power to require the person to return that property. Next, the trustee separates the exempt property from the nonexempt property and sells the nonexempt property. In addition to selling the debtor's property, the trustee has a variety of powers that assist him in fulfilling his duties. First, the trustee has the power to sue and be sued. They

can initiate collection actions but must also defend against creditor actions. They have the right to assume or reject executory contracts. Moreover, they have the right to obtain credit. Finally, the trustee has the power to void certain liens against the debtor’s property. For example, a debtor’s ability to exempt property is hindered by any liens against such possessions. Consequently, the trustee is permitted to void these liens. Exempt Property A debtor is not required to give up their exempt property. The trustee sorts the exempt property from the nonexempt property. The exemptions are stated in the Bankruptcy Code and are adjusted every three years on the basis of the consumer price index. There are federal exemptions as well as state exemptions. States, through legislation, can and have opted out of the federal exemptions to give debtors the option for state exemptions only. However, in some states, a debtor may choose whether to make state or federal exemptions; the debtor cannot make some state exemptions and some federal exemptions. Exhibit 19-4 lists the federal exemptions. In addition to having the exemptions in Exhibit 19-4, a debtor is entitled to 100 percent of Social Security benefits, veteran’s benefits, and civil service retirement benefits. Exhibit 19-4Federal Bankruptcy Exemptions Up to $25,150 for residence Interest in a motor vehicle (not necessarily an automobile) up to $4,000 Interests in personal and household goods and furnishings, clothing, appliances, books, animals, crops, and musical instruments Interest in jewelry up to $1,700 $1,325 of any property the debtor chooses (functions as a wild-card exemption) Tools of trade and professional books up to $2,525 Any unmatured life insurance contract owned by the debtor Professionally prescribed health aids The right to receive certain personal injury awards up to $25,150 Retirement funds in an IRA or SEP up to $1,362,800 per person Why has Congress created such exemptions for property? Suppose that a debtor was forced to sell all his property through liquidation. Remember, one purpose of bankruptcy is to provide a debtor with a fresh start. If a debtor were forced to sell all their property, they would likely fall right back into debt again. Thus, the exemptions are for items considered necessary to earning a living. A debtor must file a list of the property that she or he claims is exempt. Under the Bankruptcy Code and the bankruptcy rules, creditors may file objections to the claimed exemptions. If a debtor improperly lists property as exempt and a creditor does not file a timely objection, the debtor will likely be permitted to claim the property as exempt. Page 451 Preferential Payments Because a major purpose of the Bankruptcy Code is to prevent debtors from making payments to one creditor and thus treating that creditor preferentially, the trustee has the power to recover preferential payments, or payments made

by an insolvent debtor that give preferential treatment to one creditor over another. If the debtor made any payments within 90 days of the bankruptcy filing, the trustee can examine these payments as preferential payments. For a payment to be preferential, the trustee must show that the transfer gave the creditor more money than the creditor would have received through bankruptcy proceedings. Thus, other creditors are disadvantaged by the debtor's preferential payment. If the preferred creditor is an insider, such as a relative or partner, the trustee has the power to recover payments made within one year before the debtor's filing for bankruptcy. However, in such cases, the trustee must demonstrate the debtor's insolvency rather than assume insolvency. In contrast, the trustee may not recover preferential payments made for alimony or child support. Fraudulent Transfers A trustee can recover preferential payments because these payments are not fair to creditors. Similarly, a trustee can void fraudulent transfers of property. These transfers can be actually or constructively fraudulent. An actual fraudulent transfer would be made with intent to defraud creditors. Generally, there is no direct evidence of intent to defraud (e.g., an email written by a debtor who states that he is transferring assets to hide them). To show constructive fraud, a trustee would establish intent through circumstantial evidence. Similarly, if a debtor transfers property for an amount significantly lower than its fair market value, they may have engaged in a fraudulent transfer. Suppose that you are unable to pay your debts and are preparing to file for bankruptcy. You decide to sell your $50,000 boat to your business partner for $50. The trustee of your case could recover the boat if the sale occurred within two years of your bankruptcy filing. Furthermore, you could be subject to criminal penalties for your attempt to hide your assets. By punishing debtors who attempt to hide their assets, the Bankruptcy Code provides protection for creditors. Suppose that, instead of selling your boat to your business partner, you sold your boat to a creditor. Because you are making a payment to a creditor, the trustee would analyze this payment as a preferential payment (assessing how the other creditors would be harmed by this payment) rather than a fraudulent transfer (assessing the reasonableness of consideration for the transfer). LO 19-9 Explain how various creditors' claims are prioritized in bankruptcy. Creditors' Claims Within 90 days of the creditors' meeting, all creditors (except secured creditors) must file a proof of claim with the bankruptcy court clerk to receive a portion of the debtor's estate. This proof of claim lists the creditor's name and address and the amount of the debt owed to the creditor. If the creditor fails to file such a claim, the creditor may not receive a portion of the debt. However, the fact that the claim was filed does not mean that the creditor

will automatically receive a portion of the proceeds from the sale of the debtor’s assets. The trustee must permit the claim to be allowed, and there are numerous defenses to creditors’ claims. When the trustee is sorting and examining the property, the trustee must determine whether a creditor has a secured interest in the debtor’s property. If a secured interest exists, the creditor has first claim to the property. The debtor may decide to surrender the property to the creditor to satisfy the debt. Alternatively, the creditor may foreclose on the property and use the proceeds of the sale to reduce the debt owed to the creditor. However, the secured party is secured only to the value of the collateral. All creditors do not have equal claims to the proceeds of the sale. Secured parties have priority over all unsecured parties in receiving portions of the proceeds of the liquidation. Thus, secured parties are paid first. The code establishes classes of priority claims. One class must be completely paid before anyone in another class receives any payment. If there are insufficient funds to pay all the creditors in one class fully, one class is paid proportionately and the lower classes get nothing. The classes of priority claims among unsecured creditors are shown in Exhibit 19-5. Exhibit 19-5Classes of Priority Claims for Distribution Class 1 Any unpaid domestic support obligations (alimony or child support) Class 2 Court costs, trustee fees, attorney fees, and other administrative claims among expenses associated with the bankruptcy Class 3 Unsecured claims in involuntary bankruptcy that arise through the debtor’s ordinary business expenses from the date of filing the petition to the date of the appointment of the trustee Class 4 Unsecured claims for unpaid wages, salaries, and commissions earned within 180 days of filing the petition Class 5 Unsecured claims for contributions to employee retirement plans Class 6 Unsecured claims by farmers and fishermen against grain operators of grain storage facilities or fish storage or processing facilities Class 7 Claims for deposits given to the debtor in connection with property or services never given Class 8 Certain taxes and penalties due to government units Class 9 Claims in bankruptcies related to federal depository institutions Class 10 Unsecured claims for personal injuries and deaths caused by the debtor’s operation of a motor vehicle while under the influence of alcohol or drugs Discharge If a debtor has honestly dealt with her creditors during bankruptcy proceedings, the debtor is likely eligible for a discharge of her remaining debts. A discharge is a written federal court order signed by a bankruptcy judge stating that the debtor is immune from creditor actions to collect debts. When a debt is discharged, the debtor is essentially no longer responsible for the debt. Page 452 When is a discharge of debt appropriate? Discharge of debt is a privilege, not a right. A judge determines which debts are dischargeable. If

the debtor has received a previous discharge of debt within eight years of the current filing for bankruptcy, the judge will likely refuse a new discharge of debt. Exceptions to Discharge. Generally, most debts are discharged unless there are objections to the discharge or the debts are ineligible for discharge. If a major goal of bankruptcy law is to give debtors a fresh start, why are some debts nondischargeable? Some of the debts that are not dischargeable are debts to those who are in a weak bargaining position with the debtor. For example, child support and alimony payments are nondischargeable. Children and ex-spouses often depend on payments; consequently, the court will not permit the discharge of these debts. Exhibit 19-6 lists the debts that are nondischargeable as established by the Bankruptcy Code. Case 19-2 addresses one type of nondischargeable debt, specifically, loans made to a debtor for educational purposes. Exhibit 19-6Nondischargeable Debts under the Bankruptcy Code Claims for back taxes or government fines within three years of filing for bankruptcy Claims for liabilities against the debtor for obtaining money or property under false pretenses, false representation, or fraud Claims by creditors who weren't listed on the schedule and did not have notification of the bankruptcy proceedings Claims based on fraud, embezzlement, and larceny by the debtor while she or he was acting in a fiduciary relationship Alimony, child support, and some property settlements Claims of willful or malicious conduct by the debtor that caused injury to another person or property Specific student loans unless payment of the loans imposes undue hardship on the debtor Judgments against a debtor for claims resulting from the debtor's drinking and driving Debts not discharged in previous bankruptcies Claims for money borrowed to pay a tax to the United States that would be nondischargeable Cash advances on credit cards CASE 19-2 IN RE METZ U.S. BANKRUPTCY COURT, DISTRICT OF KANSAS 589 B.R. 750 (Bankr. D. Kan. 2018) FACTS: Vicki Metz filed a voluntary petition under Chapter 13 of the Bankruptcy Code in 2018. Metz had student loans totaling $16,613.73 in principal and more than $50,000 in accrued interest owing to Educational Credit Management Corporation (ECMC). The amount of Metz's payments was insufficient to service the interest accruing at 9% annually on the principal and accrued interest. Metz claimed that she could not meet a minimal standard of living if she was forced to repay the principal amount of the student loans plus the accrued interest. Metz worked as a community health worker and received gross annual pay ranging between $40,000 and $43,000. Metz was single, had no dependents, lived alone, and was in her late fifties. Her expenses consisted of rent, a car payment, health and automobile insurance premiums, a small contribution to a retirement fund,

groceries, dining out at fast food restaurants, liquor, cigarettes, and occasional visits to a casino. She occasionally exceeded her monthly budget for these items, and her bank account was overdrawn at times. ECMC opposed the request to discharge the interest payments. ISSUE: Section 523(a)(8) of the Bankruptcy Code provides that an educational loan is not dischargeable in bankruptcy “unless excepting such debt from discharge would impose an undue hardship on the debtor and the debtor’s dependents.” The court was required to determine whether Metz would suffer undue hardship if required to repay the loans in full with interest and what factors constitute a minimal standard of living to which Metz was entitled. REASONING: The bankruptcy court held that Metz was entitled to a discharge with respect to accrued interest payments but was required to repay the principal balance of her student loans. The court found that requiring Metz to repay the loans and accrued interest would impose an undue hardship. The court defined “undue hardship” as consisting of three factors. The first factor is that the debtor cannot maintain, based on current income and expenses, a “minimal” standard of living if forced to repay the loans. The second factor is that the debtor’s circumstances are likely to persist for a significant portion of the repayment period of the student loans. The final factor is that the debtor has made good faith efforts to repay the loans. The court found that Metz met all three factors. According to the court, a “minimal standard of living” requires: (1) shelter including heating and air conditioning; (2) basic utilities such as electricity, natural gas, water, and telephone service; (3) food, personal hygiene products, and decent clothing; (4) a motor vehicle, including expenses for gasoline, insurance, and maintenance; (5) health insurance or the ability to pay for medical and dental expenses; and (6) recreation even if it is just watching television or keeping a pet. Although Metz had a minimal standard of living, the court found it to be barely so, and she might be deprived of some portion of these items if she was required to repay the student loans in their entirety with interest. As to the second and third factors, the court found that Metz would not be able to pay the accrued interest on her loans in the foreseeable future. Income-based payment programs offered by the U.S. Department of Education would have allowed Metz to repay her loan over a 25 year term. However, a 25 year amortization of $67,277.88 at 9% required a monthly payment of $564.60, which Metz could not afford. The lowest possible payment of $203 would have resulted in negative amortization of $301 a month. If she made the $203 payment for 25 years, Metz’s debt would increase to $157,277.88. Furthermore, the loans were more than 25 years old, Metz did not earn a degree, she was in her late fifties, and her income

was unlikely to increase significantly over time. Finally, Metz had made good faith efforts to repay the loans over the course of 25 years with payments totaling in excess of $14,000. When a debtor shows that the requirements of Section 523(a)(8) have been satisfied for a portion of the student loan debt, the bankruptcy court may exercise its equitable powers and discharge a portion of the debt. In this case, the court found Metz could afford to make monthly payments of principal on the student loan obligations while maintaining a minimal standard of living. Such payments would be sufficient to pay the original principal of the loans over a 5 to 10 year period of time when Metz would be in her mid to late sixties. Thus, the court discharged Metz's repayment obligation other than the principal balance in order to give her a fresh start. DECISION AND REMEDY: The court held that Metz was entitled to a discharge with respect to the accrued interest payments but was still required to repay the principal balance of her student loans. SIGNIFICANCE OF THE CASE: This case sets forth a detailed definition of "undue hardship" with respect to the Bankruptcy Code provisions relating to the potential discharge of educational loans. Metz met the court's three-part test for discharge with respect to the accrued interest obligation, specifically, that she could not maintain a minimal standard of living, that such circumstances were likely to persist for an extended period of time, and that she had made a good faith effort to repay the loans. The court's definition of what constitutes a "minimal standard of living" is particularly noteworthy. However, the court did not grant an outright discharge of all obligations relating to Metz's educational loans but rather forged a compromise requiring continued efforts by the debtor to repay the principal balance. CRITICAL THINKING Do you agree with the factors identified by the court as essential to a "minimal standard of living"? What factors would you include or exclude from the list of factors? Was the court's decision too harsh in requiring Metz to repay the principal balance? Why or why not? ETHICAL DECISION MAKING How would you evaluate the court's balancing of the creditor's right to full repayment versus the debtors' right to relief pursuant to the Bankruptcy Code? What values are reflected in the court's balance of these competing interests? Page 453 Revocation of Discharge. Although a debt might be discharged, the discharge is not necessarily permanent. If the trustee or a creditor discovers that the debtor has acted fraudulently or dishonestly during the bankruptcy proceedings, the court may revoke the discharge within one year. The revocation of discharge allows the creditors to bring actions against the debtor. Page 454 Reaffirmation of Debt A debtor may wish to repay a dischargeable debt. The debtor might owe money to a family member or a longtime business associate. To maintain a good

relationship with these people, a debtor might choose to repay the debt instead of having the debt discharged. This repayment can occur through a reaffirmation agreement, an agreement in which the debtor agrees to pay the debt even though it could be discharged. Unfortunately, creditors may attempt to pressure a debtor into reaffirming a debt. Congress was worried that debtors were unwisely surrendering their ability to discharge their debts by making reaffirmation agreements. Thus, Congress created the following extensive rules so that a decision for reaffirmation of debt cannot be an impulsive one: The reaffirmation agreement must be made before the debt is discharged. The debtor must be able to cancel the agreement, and the agreement must contain explicit information regarding the time frame in which the debtor may cancel the agreement. The agreement should contain a statement notifying the creditor that the law does not require the agreement. The agreement must be filed with the bankruptcy court. Typically, the debtor's attorney files a form along with the agreement stating that the debtor is voluntarily entering the agreement and the agreement will not result in hardship to the debtor. Unless the attorney files this form, court approval for the agreement is needed. Chapter 11: Reorganizations The largest bankruptcy in U.S. history was the 2008 Lehman Brothers Holdings' bankruptcy filing. Lehman, an investment bank, had over $691 billion in assets at the time of filing. By contrast, bankruptcy filed under Chapter 11 allows the creditors and debtor to create a plan to reorganize the debtor's financial affairs under the supervision of the bankruptcy court instead of liquidating the assets. Generally, the creditors and debtor agree that part of the debt will be discharged while the other part is or will be paid. Creditors generally agree to these plans because they believe that the value of the operating business is greater than the value of the business broken up and sold in pieces. Page 455 Who is eligible for Chapter 11 reorganization? Corporate debtors most frequently use Chapter 11 reorganization because they are permitted to remain in business. However, the debtor does not have to be a business entity to use reorganization; the debtor can be an individual unrelated to business. Stockbrokers, commodities brokers, banks, and savings and loan companies are not permitted to file under Chapter 11. Most of the Chapter 11 reorganization procedures are similar to Chapter 7 liquidation procedures. Like liquidation, reorganization may be voluntary or involuntary. The reorganization process begins with the filing of the reorganization petition. When the petition is filed, an automatic stay prohibits legal action against the debtor during the reorganization process. The debtor is required to file a list of creditors. Next, the order of relief is granted, and the court appoints a trustee, who appoints a creditors' committee of

unsecured creditors. Because there may be hundreds of creditors, the creditors' committee is supposed to represent the interests of the range of creditors. The Bankruptcy Code contemplates seven creditors on the committee. The members of the creditors' committee have a fiduciary duty to the other creditors, and under BAPCPA, the creditors' committee must provide the other creditors with access to information. Generally, the trustee is responsible for developing the reorganization plan to handle the creditors' claims. The reorganization plan is a contract between a debtor and his or her creditors. The goal of the plan is to rehabilitate the debtor while preserving the assets for the creditors. Reorganization plans usually state three things: The classes of claims and interests in the debtor's property. The treatment for each class of creditors. A description of the means for execution of the agreement. A debtor has an exclusive right to file a plan within the first 120 days of the case. If the debtor files a plan within this period, no one else may file a plan within the first 180 days after the debtor's filing. This period allows the debtor time to persuade the creditors to accept the plan. Once the plan has been developed, creditors must vote to accept the plan. For the plan to be accepted, two-thirds of the creditors of each class of creditors must vote to approve it. If the plan is approved, it will go before the court for confirmation. The court may decide to reject the plan if it is not in the best interests of the creditors. When the court confirms a plan, the debts not under the reorganization plan are discharged. Collective Bargaining Agreements and Reorganization Through reorganization, a debtor can reject some contracts. In the early 1980s, legal scholars were concerned that debtors could use reorganization as a tool to avoid collective bargaining agreements. This issue became a serious concern when the Supreme Court held, in National Labor Relations Board v. Bildisco & Bildisco, that collective bargaining agreements are executory contracts and thus subject to rejection. In other words, a debtor was not required to engage in collective bargaining before rejecting part of the collective bargaining agreement through reorganization. However, in the opinion, the Court stated that rejection is not permitted unless the reorganization procedures would benefit through the rejection. After the Supreme Court decision was handed down in 1984, Congress amended the code to prevent debtors from misusing Chapter 11 to reject collective bargaining agreements. The amendments set forth procedures under which collective bargaining agreements can be rejected or modified. Chapter 13: Individual Repayment Plans Chapter 13, "Adjustments of Debts for Individuals," permits individuals to pay their debts to creditors in installment plans under the supervision of the court. Repayment plans may seem similar to reorganization. Any debtor who files under Chapter 13 could

also have filed under Chapter 11. However, Chapter 13 repayment plans are usually simpler and less expensive. By statute, these plans last between 36 and 60 months. Who is defined as a debtor for a Chapter 13 repayment plan? Only individuals are permitted to file under Chapter 13; partnerships and corporations are not eligible. Individuals must have a regular income and must owe less than $394,725 for fixed unsecured debts or $1,184,200 for fixed secured debts. Page 456 Filing the Petition As with the other forms of bankruptcy relief, the repayment process begins only when the debtor files the petition. However, repayment is distinct from other types of relief because repayment is voluntary only. A debtor cannot be forced into a repayment plan. In the petition, the debtor states that they are unable to pay their debts. The debtor might request an extension of time to pay the debts or ask the total amount of debt to be reduced. Alternatively, the debtor might request a combination of those options. As in liquidation proceedings, the debtor commonly files various schedules listing the creditors as well as the debtor's assets. Furthermore, an automatic stay on litigation against the debtor is granted when the debtor files the petition. However, one of the benefits of Chapter 13 is that this stay applies to creditors' attempts to collect from co-debtors. Creditors' Meeting and the Repayment Plan Proceedings After the debtor files the petition, the court calls a creditors' meeting. At this meeting, the debtor submits a plan of payment for their debts. This plan is not required to provide for the full payment of all claims. However, the plan must treat all same-class creditors equally, and the plan for repayment must not exceed a three-year period, unless the court approves otherwise. Creditors do not vote to approve a Chapter 13 plan; if the court approves of the plan, the plan is accepted. The court holds a hearing to determine whether to confirm the plan. Unsecured creditors may object to the plan at the hearing. However, the court can overrule their objections if all of the debtor's projected disposable income is used to make payments. If the court believes that the plan was created in good faith, the plan is accepted. However, if the plan modifies a creditor's secured claim while proposing that the debtor keep the property securing the claim, the creditor may oppose the proposed plan. Court approval of an opposed plan that changes a secured claim is called a "cram down." Since BAPCPA, it has been harder for debtors to make changes to secured claims over the objections of creditors. After the court approves the plan, the court appoints a trustee to carry out the repayment plan. Every Chapter 13 case has a trustee. The debtor makes monthly payments to the trustee based on their disposable income. The trustee then disburses payments to the creditors. Moreover, as payment for services, the trustee receives a percentage of the

funds distributed to creditors. Thirty days after the debtor files the plan, the debtor must begin making payments. The trustee must ensure that the debtor is making the payments. If the debtor fails to make payments, the court may decide to transfer the case to a liquidation bankruptcy or to refuse to grant the repayment plan. Discharge of Debts under Repayment Proceedings After a debtor makes all payments under a repayment plan, the remaining debts are discharged. However, even if all payments are not made by the expiration of the plan, the court might discharge some of the debts if the debtor has experienced a severe hardship. Like liquidation, some debts, such as alimony and child support debts, are not dischargeable. Chapter 12: Family-Farmer and Family-Fisherman Plans Chapter 12 provides for adjustment of the debts of family farmers or family fishermen. Chapter 12 was added to the code in the 1980s in the midst of severe debt among large numbers of farmers. Many farmers had borrowed large amounts of money to increase their production; however, during that time, there was a surplus of farm products. Consequently, many farmers faced serious financial problems. Congress addressed these problems with Chapter 12. Not all farmers and fishermen are eligible for Chapter 12 relief. A family farmer or fisherman, under Chapter 12, must have regular annual income and be either (1) an individual or individual and spouse or (2) a corporation or partnership. A family farmer’s or family fisherman’s gross income must be at least 50 percent farm- or fishing-dependent. Moreover, 50 percent of the farmer’s debt must be farm-related, and 80 percent of the fisherman’s debt must be fishing-related. Finally, the total debt must be under $1.9 million for a family fisherman and $4.1 million for a family farmer. Page 457 What are the family-farm and family-fisherman relief proceedings? Congress modeled Chapter 12 after Chapter 13 relief. The procedure begins when the farmer or fisherman files a Chapter 12 petition. An automatic stay is granted to protect the farmer or fisherman from legal action. Within 90 days of the filing, the farmer or fisherman must file a plan. A trustee is appointed to oversee the financial affairs and is permitted to sell unnecessary assets. The court holds a hearing to rule on the proposed plan. Unsecured creditors are entitled to at least liquidation value of the debt owed to them. Once the farmer or fisherman fulfills his or her adjustment plan, the farmer or fisherman will likely receive a discharge from his or her debts and retain possession of the farm or fishery and related personal property. CASE OPENER WRAP-UP Prosperity Bank The Texas Court of Appeals upheld the trial court’s deficiency judgment award of $1,356,493.79 against Airpro Mobile Air. The court held that Prosperity Bank’s actions and subsequent sale of the collateral were commercially reasonable. The court held that Prosperity made commercially reasonable

efforts to dispose of the collateral. The court found that Prosperity made extraordinary efforts to gain access to the collateral, including filing a lawsuit against H&H. Prosperity even attempted to rent the premises from H&H in order to gain access to the collateral which efforts proved unsuccessful. H&H's interference prevented Prosperity from inspecting, managing, marketing, or appraising the collateral or moving it to a space where it could host a public sale. The court also held that the $17,500 sale price was commercially reasonable. The court stated that the ultimate purpose of a commercially reasonable sale is to ensure the creditor realizes a satisfactory price. A satisfactory price is not necessarily the highest price, and secured creditors often sell in the low end of wholesale markets. The mere fact that a higher price could have been obtained is not preclusive to a finding of commercial reasonableness. The price that Prosperity realized for the collateral was supported by numerous witnesses and was reasonable given that much of the equipment was obsolete and missing component parts. PRACTICAL TIPS for Business Managers Compliance with the technical requirements including filing rules and deadlines are imperative if a secured creditor wishes to preserve its position with respect to the collateral and in relation to other creditors. Failure to strictly follow the rules places a creditor in jeopardy of losing its secured position and ending up as an unsecured creditor. It is imperative for secured creditors to conduct due diligence with respect to the debtor's business activities and status of the collateral. Sales and movement of the collateral may negatively affect an unsuspecting secured creditor's status. Secured creditors must act in a reasonable manner when they seek to repossess collateral upon default. Creditors must keep in mind that the actions of those retained to conduct the actual repossession can and will be attributed to them and may result in unanticipated and unwelcome liability. Laws relating to bankruptcy are extremely complex with many technical requirements including pre-petition credit counseling, document filing requirements, automatic stays, and notice provisions. Compliance is imperative from the perspective of debtors and creditors. Failure to strictly follow the rules places a debtor's ability to obtain a discharge or a creditor's ability to recover on its claim in jeopardy. Debtors and creditors should not navigate the intricacies of bankruptcy without at least the advice, if not representation, of legal counsel. Truthfulness and full disclosure matter in bankruptcy. Bankruptcy is not the time for dishonesty, obfuscation, or denial. Bankruptcy proceedings lay bare a debtor's financial position without exaggerations or misrepresentations. This may be discomforting or embarrassing for some debtors. However, it must be remembered that a discharge of debts is a privilege and not a right and may

be denied to debtors who make less than complete and truthful financial disclosures. Bankruptcy should be a last resort for debtors and creditors. Although the stigma of bankruptcy has been somewhat alleviated, it nevertheless has serious implications for a debtor’s future financial dealings. Contrary to popular belief, debtors cannot declare bankruptcy, keep all of their assets, and discharge their debts. Creditors should try to avoid bankruptcy as well. Not only might creditors lose a portion of the value of their claims, but they are also subject to the rulings of a federal bankruptcy court with respect to repayment. Bankruptcy may be avoided in many situations by honest and open dialogue between creditors and debtors.

SUMMARY Important Definitions Associated with Secured Transactions Secured interest: An interest in personal property or fixtures that secures payment or performance of an obligation. Secured party: The person or party that holds the interest in the secured property. Debtor: The person or party that has an obligation to the secured party, the person who owns interest in the property. Security agreement: The agreement in which the debtor gives the secured interest to the secured party. Collateral: The property that is subject to the security interest. Creation of Secured Interests Attachment of a security interest requires these three elements: Written agreement: An agreement that describes the collateral and is signed by the debtor. Value: An item of value given from the creditor to the debtor. Debtor rights in the collateral: The rights of the debtor over the collateral. Purchase-Money Security Interest A purchase-money security interest is formed when a debtor uses borrowed money (e.g., buying on credit) from the secured party to buy the collateral. Perfected Security Interest A perfected security interest is a security interest in which the creditor has legally protected his or her claim to the collateral. Methods of perfection include: Perfection by filing: Perfection of an interest by filing a financing statement with a state agency. Place and duration of filing: Generally, the financial statements for consumer goods must be filed with the county clerk, and the statement is valid for five years. Perfection by possession: Perfection of an interest by holding the collateral of the debtor until the loan is paid off. Automatic perfection: Perfection that automatically occurs when a retailer sells a consumer good. Perfection of movable collateral: Perfection of an interest in collateral moved to another state by reperfecting the interest after four months. Perfection of security interests in automobiles and boats: Perfection of an interest in an automobile or boat by noting the interest on the certificate of title. The Scope of a Security Interest After-acquired property: A creditor has a security

interest in property acquired by the debtor after the security agreement is made, if a clause to this effect is included in the agreement. Proceeds: A creditor automatically has rights to the proceeds from the sale of collateral for 10 days. Termination of a Security Interest Termination statement: An amendment to a financing statement, stating that the debtor has no obligation to the secured party. Priority Disputes A priority dispute occurs when two creditors claim rights to the same collateral. Secured versus unsecured: When an individual with a secured interest is disputing with an individual with an unsecured interest, the individual with the secured interest wins. Secured versus secured: When two individuals with secured interests are disputing, the individual who perfected his or her interest first wins. PMSI conflicts: If a party with a perfected purchase-money security interest disputes with another party, the PMSI party will almost always have a right to the collateral—regardless of when the agreement was perfected. Secured party versus buyer: If a debtor sells his collateral, the creditor may dispute with the buyer over the collateral. Buyers in the ordinary course of business: If a person buys the collateral in the ordinary course of business without realizing that it is collateral, they have a right to the good. Buyers of consumer goods: As long as the consumer does not know that the product is secured, the buyer’s new product is free of any security interest. Buyers of chattel paper and instruments: If the buyer purchases chattel paper and instruments, they are free from any security interest. Default Default occurs when a debtor fails to pay back their loan. Remedies include: Taking possession of the collateral: If a debtor defaults on a loan, the secured party can take possession of the collateral. Disposition of the collateral: The creditor may sell, lease, or transfer the collateral. Retention of the collateral: The creditor may choose to keep the collateral as payment of the debt. Proceeding to judgment: A secured party may sue the debtor for the entire amount of the debt instead of dealing with the collateral. Bankruptcy and Reorganization A debtor is an entity that owes money to another entity. Bankruptcy law provides various options for debtors to resolve their debts. Bankruptcy remedies are available to individuals, partnerships, and corporations. The Bankruptcy Act and Its Goals Purpose: To provide debtors with an opportunity to achieve a fresh financial start. To offer protection to creditors. Bankruptcy Proceedings Every case begins with the filing of a petition for bankruptcy. The court grants an automatic stay for creditor actions against the debtor’s estate. The court determines whether an order of relief should be granted. The creditors meet with the debtor. A payment plan is created and approved, usually by the creditors and the court. Debts remaining after the plan is carried out are usually discharged. Specific Types

of Relief Available Chapter 7: Sale of nonexempt assets and the distribution of money to the creditors. Chapter 11: Reorganization of the debtor's financial affairs under supervision of the bankruptcy court. Chapter 12: Adjustment of family farmer's or fisherman's debts. Chapter 13: Adjustment of individual's debts.

Point/Counterpoint Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, individual debtors must now complete a credit-counseling requirement before filing under Chapter 7. Is the Credit-Counseling Requirement Helpful to Consumers? YES NO Congress's intent in including the credit-counseling requirement was to provide consumers with more information. Whether the counseling takes place in person, over the telephone, or over the Internet, the consumer gains a better understanding of their debt. Generally, the consumer explains how the debt developed. A credit counselor reviews the consumer's monthly income, expenses, liabilities, and assets. The consumer reviews options for dealing with debt; not every case needs to proceed through bankruptcy. The prefiling counseling requirement succeeds in giving consumers more power by enabling them to understand their options. This requirement is helpfulto consumers. The credit-counseling requirement does not provide real information to consumers. Under BAPCPA, the credit counselors must charge a "reasonable fee" for their service. Generally, consumers have been paying $50 for the service, which is a significant amount of money to a person filing for bankruptcy. Because the debtor is required to complete the counseling before filing, the debtor may be persuaded to partake in a debt management plan. The counseling agency frequently receives part of the debts repaid in the debt management plan. The debtor may not be in a position to properly evaluate the debt management plan in relation to the bankruptcy.

Questions & Problems What are the required elements of a security interest? Describe the various ways in which secured interests are perfected. How does bankruptcy law benefit debtors and creditors? Under what circumstances would Chapter 11 be used rather than Chapter 7? Between July 2007 and July 2008, N&N Partners LLC executed three agreements to finance the purchase of commercial equipment. The collateral securing N&N's obligations under each agreement was the equipment being purchased. All three agreements were subsequently assigned to Colonial Pacific Leasing Corporation. N&N defaulted under the agreements by failing to make the payments as they came due in September 2009. The collateral

was repossessed and sold in December 2009 and March 2010. Before each sale, N&N received notice and had an opportunity to redeem the collateral. After the sales, the proceeds were credited to N&N's account, but a debt remained. Colonial filed an action seeking a deficiency judgment in the amount of $101,094.14. N&N admitted its default but claimed that the sales of the collateral were not commercially reasonable due to technical flaws in the notices of sale, the fact that the sales occurred too early in the morning to allow for full public participation, and that Colonial failed to appraise the equipment before the sales, thereby preventing it from proving the fair market value of the equipment prior to the sales. Colonial alleged that the sales were commercially reasonable as N&N received timely notice; the sales occurred at a time, place, and in a manner typical for this type of collateral; and the proceeds equaled or even exceeded the collateral's fair market value. Should technical errors in the notices of sale render the sales commercially unreasonable? Should sales occur later in the day to maximize participation? Should the creditor have to provide an appraisal of all collateral sold in order to satisfy the commercially reasonable sale requirement? Source: Colonial Pac. Leasing Corp. v. N&N Partners, LLC, 981 F. Supp.2d 1345 (N.D. Ga. 2013). In November 2007, Shirley Bolden entered into a conditional sales contract, which was assigned to M&T Bank for the purchase of a Mercedes-Benz automobile. Bolden took physical possession of the car, and M&T retained a security interest in it. Bolden defaulted on the loan and the car was repossessed in March 2011. Bolden received notice of M&T Bank's intent to sell the car at a private sale. The car sold at the private sale in April 2011 for $3,900. The balance due on the loan at the time of the sale of the car was $15,668.86. The sales agent placed the car in a "dealers only" sale in which only car dealers can attend and purchase vehicles. There was no evidence as to how the sale was advertised or conducted, how many bidders were present, how many people actually bid on the car, or that the sale was in accordance with accepted industry practices. At the time that the car was sold, the trade-in value of similar automobiles in good condition was $6,100. However, Bolden's car was in below average condition. M&T Bank sought recovery of the $11,768.86 deficiency balance left after reducing the total amount due on the loan by the sales proceeds. Bolden contended that the sale was commercially unreasonable. Did the private nature of the sale and surrounding circumstances render the sale commercially unreasonable? Why or why not? Source: M & T Bank v. Bolden, 2012 WL 6628947 (Del. Ct. Common Pleas 2012). In November 2006, Texana Rice Mill and Texana Rice, Inc. sued Bayer CropScience in Texas state court for several claims related to the contamination of the United States rice supply by Bayer's genetically

modified rice. Texana alleged the contaminated rice damaged its property including its rice, plant, and equipment. Texana and Bayer reached a settlement for $2,137,500, and Bayer made payment into the custody of the clerk of court. After two uncontested disbursements, the sum of $933,697.90 remained. Texana owed separate debts to Stearns Bank National Association and Amegy Bank National Association, which were in excess of the remaining settlement proceeds. Stearns's loan was made in September 2002 and was secured, in part, by Texana's equipment and all proceeds from its sale, destruction, loss, or other disposition. Amegy's loan was made in February 2006 and subsequently secured by its claim against Bayer. Stearns and Amegy's security interests were perfected. Stearns and Amegy both claimed a right to the remaining settlement proceeds based upon their respective security interests. To whom should the settlement proceeds belong—Stearns or Amegy? What are the reasons for your answer? Source: Bayer Cropscience, LLC v. Stearns Bank Nat'l Ass'n, 837 F.3d 911 (8th Cir. 2016). Page 461Campogan was a licensed childcare provider who cared for children in her home. She had a contract with Troy and Wendy Wurtz to care for their infant daughter Zoe. The contract required Campogan to adhere to safe sleep guidelines. Zoe died of hyperthermia as a result of Campogan placing her in a car seat, with a blanket behind her back and a pillow on her lap, in a warm bedroom, while Campogan was attending to other children in an adjacent room. Campogan's conduct was unsafe and did not comply with the safe sleep guidelines that she had promised to follow. Campogan subsequently filed for bankruptcy. The Wurtzs objected to the entry of a discharge of Campogan's debt to them arising out of Zoe's death. Campogan contended that Zoe's death was a tragic accident, but the Wurtzs argued that Campogan's failure to abide by safe sleep guidelines resulted in willful and malicious injury. Was Zoe's death a willful and malicious injury such that Campogan should be denied a discharge in bankruptcy? Why or why not? Source: In re Campogan, 2019 WL 4580360 (Bankr. Hawai'i 2019). In June 2003 and November 2005, The Four County Bank provided financing for the purchase of two different pieces of foresting equipment known as "Tigercats" by Shepherd Brothers Timber Company. Four County perfected its security interests in both pieces of equipment by filing financing statements. While Four County's original financing statements were still effective, Shepherd sold both pieces of equipment to Tidewater Equipment Company, which later resold them. In October 2008 and March 2011, more than five years after the filing of each of the original financing statements, Four County attempted to file continuation statements as to the equipment. After Shepherd declared bankruptcy, Four County sued Tidewater to recover the equipment or its

value. Four County argued that Tidewater was liable for the value of the equipment because Tidewater should have known of Four County's perfected security interest at the time Tidewater resold the equipment. Do you agree with Four County's argument? Why or why not? Source: The Four County Bank v. Tidewater Equipment Co., 771 S.E.2d 437 (Ga. Ct. App. 2015). Simon and Clayton became involved in a fistfight outside of a diner in Lafayette, Louisiana, in October 2010. Simon claimed Clayton disrespected him by speaking with Simon's girlfriend who was seated in Simon's pickup truck while Simon was in the diner. Simon punched Clayton and then attempted to leave the parking lot. However, Clayton removed the keys from Simon's truck in order to keep him from leaving before the police arrived. Simon responded by striking Clayton, knocking him to ground and then repeatedly punching him. Clayton was hospitalized as a result of his injuries and incurred more than $14,000 in medical expenses. Clayton sued Simon in Louisiana state court and received a default judgment. Simon subsequently filed a Chapter 7 bankruptcy petition seeking to discharge Clayton's judgment. Clayton objected and claimed the damages award was non-dischargeable as his injuries resulted from Simon's willful and malicious acts. Simon claimed Clayton provoked the fight, he did not intend to harm Clayton but was only attempting to retrieve his keys and defend himself, and Clayton consented to the battery as a willing participant in the fight. Was Simon's conduct willful and malicious such as to prevent the discharge of the debt owed to Clayton? What effect should state tort law doctrines have on the outcome of bankruptcy proceedings? Source: In re Simon, 2017 WL 4118284 (Bankr. W.D. La. Aug. 3, 2017). On November 25, 2013, Arkuszewski filed a petition for relief under Chapter 13 of the Bankruptcy Code. Arkuszewski did not file a certificate regarding a credit counseling briefing by December 9, 14 days after filing her bankruptcy case. On December 11, the trustee filed a motion to dismiss based on the absence of the certificate. Arkuszewski did not contest the motion, and an order dismissing the case was entered. On February 11, 2014, Arkuszewski moved to vacate the order of dismissal and claimed that she filed the certificate on December 19, 2013. The certificate that Arkuszewski filed stated she received the required counseling on November 25, 2013, at 7:31 p.m. after the bankruptcy clerk's office in Chicago had closed. Arkuszewski stated that she had begun the process of obtaining credit counseling before she filed the case, but she did not complete the process and receive the briefing until afterward. She further stated that an employee of the bankruptcy clerk's office told her that this would be "good enough" for her petition to proceed. Should the court dismiss Arkuszewski's petition due to noncompliance with the credit-counseling

requirement? Was Arkuszewski’s reliance on the statement of the bankruptcy clerk’s office justified? Source: In re Arkuszewski, 507 B.R. 242 (Bankr. N.D. Ill. 2014). Page 462Ganci filed a lawsuit against Townsend in July 2010 alleging sexual harassment and intentional infliction of emotional distress. Ganci’s claims were based, in part, on an alleged sexual assault in the workplace, text messages and voice mails of a sexually explicit nature, and attempts to initiate a sexual relationship over an extended period. At trial, the jury held for Ganci on her sexual harassment claim but rejected her claim of emotional distress. The jury awarded Ganci $450,000 in compensatory damages and $100,000 in punitive damages against Townsend. The trial court set aside the punitive damages award after determining that such damages were not available under federal or New York law. Townsend filed a Chapter 7 bankruptcy petition seeking to discharge the judgment entered in Ganci’s favor. Ganci commenced a proceeding in Townsend’s bankruptcy seeking a determination that the judgment was non-dischargeable. The U.S. Bankruptcy Court for the Eastern District of New York agreed with Ganci and held that the judgment was non-dischargeable as it was based upon a willful and malicious injury. Townsend appealed the ruling to the district court and claimed that the jury’s rejection of Ganci’s emotional distress claim established that he did not act willfully. How should the court define “willful” for purposes of determining whether Townsend was entitled to a discharge? Is the rejection of Ganci’s emotional distress claim and punitive damages award relevant to this determination? Source: Townsend v. Ganci, 566 B.R. 129 (E.D.N.Y. 2017). Alan and Catherine Murray filed a voluntary petition under Chapter 13 in September 2014. The Murrays had student loans totaling $77,524 in principal and more than $200,000 in accrued interest owing to Educational Credit Management Corporation (ECMC). The Murrays made regular payments and were never late, but the amount of their payments was insufficient to service the interest accruing at 9% annually on the principal and accrued interest. Interest payments alone accrued at the rate of $65.89 per day. The Murrays claimed that they could not meet a minimal standard of living if they were forced to repay the principal amount of the student loans plus the accrued interest. The Murrays had a monthly net income of $6,100 and monthly expenses of $4,442 resulting in disposable monthly income of $1,658 at the time of their bankruptcy filing. This amount included no funds for emergencies, no savings for a down payment on a home, no savings for retirement, no vacations, and $50 per month for entertainment other than cable television. ECMC opposed their request to discharge the interest payments. How should the court apply the undue hardship factors identified in the Case Opener to these facts? Should

the Murrays receive a full or partial discharge of their student loan obligations? Source: In re Murray, 563 B.R. 52 (Bankr. D. Kan. 2016). Miller filed for Chapter 7 bankruptcy protection on April 26, 2013. Based upon the filing date, the period for determining Miller's current monthly income was October 1, 2012, through March 31, 2013. Miller calcu-lated that his annual current income was $73,228.36, or $6,111.53 per month. The trustee filed a motion to dismiss Miller's bankruptcy case based on abuse of the provisions of Chapter 7. The trustee calculated Miller's current monthly income to be $6,601.91. The disagreement stemmed from a paycheck Miller received on October 10, 2013, for $2,942.66, for wages that were earned prior to the statutory six-month period. The issue was thus whether the definition of "current monthly income" encompassed all of Miller's income received during the prescribed six-month period, or whether the income must have been both received and earned during that period. Miller contended "current monthly income" should be defined to require both received and earned during the look-back period. The trustee argued that the definitions of "received" and "derived" were synonymous and included all income received by a debtor during that period. Was Miller's statement of his income inac-curate such as to merit dismissal of his bankruptcy petition? Source: In re Miller, 2013 WL 6331050 (Bankr. D. Wyo. 2013). Bolles and an unidentified plaintiff met on Tinder in 2015. They initiated a relationship that became intimate. Prior to their first sexual encounter, the plaintiff asked Bolles if he had "anything I need to worry about?" Bolles understood this question as asking whether he had any sexually transmittable diseases. Bolles stated "oh gosh no" or something similar, in response to the plaintiff's question. In reliance upon Bolles's response, the couple engaged in unprotected sexual intercourse. Bolles and the plaintiff engaged in unprotected intercourse on several occasions thereafter. In fact, Bolles had genital herpes. Bolles suffered an outbreak in 2014 and sought medical treatment at which time he received a positive diagnosis. Bolles knew herpes was easily transmitted through unprotected sexual intercourse and lied to the plaintiff because he knew if he told the truth, she would not have sex with him. The plaintiff subsequently contracted herpes from Bolles. Bolles admitted that he was to blame and that he knew about his condi-tion before their first sexual encounter. The plaintiff suffered significant physical pain and psychological injury as a result of her diagnosis. The plaintiff sued Bolles in New Mexico state court for fraud, inten-tional infliction of emotional distress, and battery. Bolles filed for bankruptcy before the plaintiff's case could be tried. The plaintiff objected to Bolles's discharge of her claims by the bankruptcy court. Was Bolles's misrepresentation of his medical status willful, intentional, and

malicious to the degree necessary to deny him a discharge of the plaintiff’s claims in bankruptcy? Why or why not? Source: In re Bolles, 593 B.R. 832 (Bankr. D.N.M. 2018). Page 463Brent Hickman owned 50 percent of HLMR, LLC d/b/a Brent’s Cajun Seafood & Oyster Bar as general manager. Prior to June 2018, Hickman deposited his salary into an account at Prosperity Bank under his name. In June 2018, Hickman’s wife Berta opened an account in her name only at Prosperity Bank. From June 2018 through September 2018, Hickman deposited his salary into his wife’s bank account. In July 2018, Hickman sold his interest in HLMR to Floyd Landry for $25,000. Hickman testified that the reason for the sale was that he needed the money to pay back taxes. On July 20, 2018, Hickman deposited the $25,000 from the sale into his wife’s bank account. Hickman utilized money from this account to pay his attorney for bankruptcy services, take a vacation to Cabo San Lucas, Mexico, dine out and for miscellaneous other personal expenses. Hickman did not remit any of this money to the Internal Revenue Service. On August 31, 2018, Hickman filed for Chapter 7 bankruptcy. In his petition, Hickman stated that he was the sole proprietor of HLMR. Hickman’s statement of financial affairs stated that he did not sell, trade, or otherwise transfer property to anyone other than in the ordinary course of business within two years preceding the filing of bankruptcy when in fact he sold his interest in HLMR to Landry. Hickman further failed to disclose the $25,000 he received from Landry. Hickman also did not disclose that he had been putting his salary into his wife’s bank account. Hickman’s creditors brought an adversary proceeding to deny him a discharge due to his false statements. What are the duties of those seeking bankruptcy protection with respect to the disclosure of their assets and liabilities? Should Hickman’s failure to fully and truthfully disclose his assets result in a denial of a discharge in bankruptcy? Source: In re Hickman, 616 B.R. 815 (Bankr. W.D. Okla. 2020).